(1)

No. 94, Original

IN THE

Supreme Court of the United States

OCTOBER TERM, 1984

STATE OF SOUTH CAROLINA,
Plaintiff,

v.

DONALD T. REGAN, SECRETARY OF THE TREASURY OF THE UNITED STATES OF AMERICA

REPORT OF SPECIAL MASTER ON MOTION OF NATIONAL GOVERNORS' ASSOCIATION FOR LEAVE TO INTERVENE AS PLAINTIFF

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REPORT OF SPECIAL MASTER ON MOTION OF NATIONAL GOVERNORS' ASSOCIATION FOR LEAVE TO INTERVENE AS PLAINTIFF

INTRODUCTION

On February 9, 1983, the State of South Carolina sought leave to file a complaint invoking the Supreme Court's original jurisdiction and challenging the constitutionality of Section 310(b)(1) of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), Pub. L. No. 97-248, 96 Stat. 596. In *South Carolina v. Regan*, —— U.S. ——, 104 S. Ct. 1107 (1984), after briefing and argument, the Court granted leave to file the complaint, and by its Order of April 23, 1984, it appointed the undersigned, Samuel J. Roberts, to serve as Special Master.

On May 17, 1984, the Special Master held a status conference at which the parties agreed on a schedule of

further proceedings. The Secretary of the Treasury filed his answer to the complaint on June 1, 1984, and South Carolina submitted a statement of position, an outline of its evidence and a proposed witness list on July 30. The Secretary of the Treasury submitted his issues and witness list on September 21.

On June 22, 1984, the National Governors' Association ("NGA") moved for leave to intervene as plaintiff. The original parties have submitted briefs in opposition to this motion, asserting a number of grounds for denying NGA's motion. The Court referred this motion to the Special Master for his recommendation by its Order of August 16, 1984. The Special Master heard oral argument on the motion on October 8, 1984.

For the reasons discussed below the Special Master recommends that the motion for leave to intervene should be granted, as conditioned herein. The Special Master respectfully suggests, in accordance with previous practice,[1] and with the concurrence of all the parties, that the Court postpone its review of this recommendation until the conclusion of the case when the Special Master's final Report is submitted. In the interim, the Special Master recommends that the Court should simply order this Report filed, allowing the parties, if they so desire, to file exceptions to this recommendation at the conclusion of the case when the Special Master's final Report is submitted.

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[1] *See* Report of Special Master on Motion of Inupiat Community of the Arctic Slope and Ukpeagvik Inupiat Corporation for Leave to Intervene, *United States v. Alaska*, No. 84, Original (Jan. 10, 1984) at 1; *Arizona v. California*, 444 U.S. 1009, 1010 (denying Arizona leave to file exceptions to Special Master's preliminary report on, *inter alia*, intervention). *Cf. Ohio v. Kentucky*, 410 U.S. 641, 644 (1973) ("Our object in original cases is to have the parties, as promptly as possible, reach and argue the merits of the controversy presented.").

DISCUSSION

In granting South Carolina leave to file its complaint in this original action, the Supreme Court recognized the breadth and magnitude of the federalism concerns it raised. Justice Brennan, in an opinion joined by Chief Justice Burger, Justice White, and Justice Marshall declared "[u]nquestionably, the manner in which a State may exercise its borrowing power is of vital importance to all fifty States." *South Carolina v. Regan*, slip opinion at 13 (plurality opinion of Brennan, J.). Justice Blackmun, concurring in the judgment, agreed that "[t]he issue presented is a substantial one, and is of concern to a number of States." Slip opinion at 3 (concurring opinion of Blackmun, J.). Justice O'Connor, in an opinion joined by Justice Powell and Justice Rehnquist, concurring in the judgment, first noted that South Carolina had demonstrated by clear and convincing evidence that it had suffered an injury of serious magnitude, and then observed that the fact that twenty-four states had filed a joint brief *amicus curiae* further "attest[ed] to the 'serious magnitude' of the federalism concerns at issue." Slip opinion at 17-18 (concurring opinion of O'Connor, J.).

Because of the complexity, national scope and public importance of the questions presented by South Carolina's complaint, the Court deemed the record insufficiently developed to permit it to address the merits. *See South-Carolina v. Regan*, slip opinion at 13 (plurality opinion of Brennan, J.); slip opinion at 19 (concurring opinion of O'Connor, J.). Its subsequent appointment of a Special Master comports with its traditional handling of such cases: "[t]he Court in original actions, passing as it does on controversies between sovereigns which involve issues of high public importance, has always been liberal in allowing full development of the facts." *United States v. Texas*, 339 U.S. 707, 715 (1950).

The NGA is an incorporated instrumentality of the States, the members of which are the chief executives of

the fifty States, two Commonwealths and three territories. *Brief of NGA* at 13. Its purpose is to represent the States in the federal system. *Id.* It seeks to intervene in this action in order "to represent the collective interests of the States and to assist in the development of the complete factual record necessary for disposition of this case." *Id.* at 9-10. The original parties do not dispute that NGA's claims have a question of law or fact in common with South Carolina's; indeed, as the NGA asserts, those claims are identical. *NGA's Brief* at 15-16; *Defendant's Brief* at 5; *Plaintiff's Brief* at 2. The NGA is the only party that has sought leave to intervene to date, notwithstanding the fact that South Carolina sought leave to file a complaint 21 months ago, the Court granted leave nine months ago and five months have elapsed since NGA sought to intervene.

In these circumstances, the Special Master believes that permitting the NGA to intervene, with appropriate conditions, will be an efficient way to ensure that the views of all the States on the truly national questions involved here will be heard with a minimum of duplication and delay. Since the NGA is a single party, its intervention will not expand this cause "to the dimensions of ordinary class actions." *New Jersey v. New York*, 345 U.S. 369, 373 (1953). Instead, its participation will allow a consolidated presentation of a broader spectrum of views than would be potentially available were South Carolina the only party plaintiff.

Moreover, since the purpose of appointing a Special Master is to ensure the development of a complete record, allowing the NGA to intervene will facilitate the requisite full factual development. The NGA's interests, constituencies and resources are necessarily broader than those of any one State. Therefore, the NGA is well situated to address both the nationwide fiscal impact of Section 301(b)(1) of TEFRA and its effects on the decision-making processes of State governments.

In order to ensure that permitting the NGA to intervene does not delay or prejudice the adjudication of the rights of the original parties, the Special Master recommends that the Supreme Court condition the exercise of its discretion as follows:

1. The NGA will submit its statement of position, outline of proposed proof, and tentative witness list within 30 days after the Supreme Court orders this Report filed.[2]

2. The NGA will coordinate its presentation with that of South Carolina. The order of proof and testimony of the original plaintiff and of the intervenor must be structured in a logical sequence which avoids duplication or accumulation; where they are not so structured, the United States will be entitled to object appropriately.[3]

3. No further motions to intervene will be entertained by the Special Master at this late date.[4]

South Carolina and the Secretary of the Treasury raise a number of objections to the NGA's participation as a

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[2] In its *Reply Brief* at 8, the NGA stated that if permitted to intervene, it would be prepared to adhere to any schedule set by the Special Master for South Carolina.

[3] *Accord* Memorandum and Report on Preliminary Issues, *Arizona v. California,* No. 8, Original (August 28, 1979), at 15-16 (Tuttle, J., Special Master).

[4] The Secretary of the Treasury expresses his concern that, if the NGA is allowed to intervene, it would be difficult to articulate a principled basis for denying intervention by other groups. *Defendant's Brief* at 12. I am not similarly troubled. During the pendency of NGA's motion to intervene, no other potential intervenor has stepped forward; indeed, a number of representative organizations have disclaimed any intention to intervene. Twenty months have now elapsed from South Carolina's initial request for leave to file a complaint. Any future motion to intervene will be dismissed as untimely. *See* Fed. R. Civ. P. 24(a) and (b); Supreme Court Rule 9.2 (Federal Rules of Civil Procedure may be taken as a guide to procedure in original actions where appropriate).

party. They suggest that the NGA can participate most effectively and expeditiously by filing a brief *amicus curiae*. The role of an *amicus*, however, is limited to providing the Court with more or less neutral advice on questions of law; it generally does not extend to partisan presentation of facts, or participation in evidentiary proceedings. *See, e.g., New England Patriots v. University of Colorado*, 592 F.2d 1196, 1198 n.3 (1st Cir. 1979); *Allen v. County School Board of Prince Edward County*, 28 F.R.D. 358, 362 n.2 (E.D. Va. 1961). NGA's legal contentions do not differ in any respect from South Carolina's. The role it envisions for itself, and the lacuna which the Special Master believes it can fill, is to enhance the evidentiary record with a broad national perspective on Section 310(b)(1)'s impact both on the States' fiscs and on their internal decision-making processes.[5] It will do this efficiently by presenting the views of the other 49 states in a unitary manner.

Second, and more fundamentally, the original parties urge that intervention be denied because the NGA fails to meet the requirements for permissive intervention under Fed. R. Civ. P. 24(b)(2). They argue that since the NGA is not a State, it can assert no independent jurisdictional grounds for invoking the Court's original jurisdiction. In these circumstances, the parties assert that permitting the NGA to intervene would be an unwarranted expansion of the Court's original jurisdiction, which should be exercised "sparingly." *United States v. Nevada*, 412 U.S. 534, 538 (1973).

This argument fails for two reasons. First, and most importantly, Supreme Court precedent simply does not

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[5] *South Carolina v. Katzenbach*, 383 U.S. 301 (1966), is not to the contrary. In that case, "of urgent concern to the entire country," the Court invited all of the States to participate as friends of the Court. *Id.* at 307. The Court explicitly recognized that "no issues of fact were raised in the complaint," and therefore deemed the *amicus* role to be most appropriate. *Id.*

support the mechanical transplantation of the "independent jurisdictional basis" requirement of Fed. R. Civ. P. 24(b)(2) into the original jurisdiction context. The Court has repeatedly sanctioned permissive intervention in original jurisdiction cases by non-sovereign parties who are inherently unable to establish independent jurisdictional grounds. In *Arizona v. California*, 460 U.S. 605 (1983), for example, the Court allowed five Indian Tribes to intervene in an original action between two States. Rejecting the States' argument that the prerequisites for intervention of right under Fed. R. Civ. P. 24(a)(2) had not been satisfied, the Court declared:

> Aside from the fact that our own Rules make clear that the Federal Rules are only a guide to procedures in an original action, see this Court's Rule 9.2; *Utah v. United States*, 394 U.S. 89, 95 (1969), it is obvious that the Indian Tribes, at a minimum, satisfy the standards for *permissive intervention* set forth in the Federal Rules. The Tribes' interests in the water of the Colorado basin have been and will continue to be determined in this litigation since the United States' action as their representative will bind the Tribes to any judgment. . . . Moreover, the Indians are entitled 'to take their place as independent qualified members of the modern body politic.' . . . Accordingly, the Indians' participation in litigation critical to their welfare should not be discouraged. The States have failed to present any persuasive reason why their interests would be prejudiced or this litigation unduly delayed by the Tribes' presence. The Tribes' motions to intervene are sufficiently timely with respect to this phase of the litigation. . . . The motions to intervene are granted.

Id. at 614-15 (emphasis supplied and citations omitted).[6]

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[6] The Supreme Court's refusal to import the independent jurisdictional grounds requirement wholesale into its original jurisdiction cases is not surprising. The independent jurisdictional basis

Similarly, in *South Dakota v. Nebraska*, 434 U.S. 948 (1977), the Special Master, Oren Harris, J., permitted South Dakota citizens to intervene on the side of the defendant, Nebraska, over the objections of South Dakota. The Special Master reasoned that "[t]he intervenors' claims and defenses as to the major questions of law or fact are in common with those asserted by the defendant and . . . the exercise of the Court's discretion in permitting intervention will not unduly delay or prejudice the adjudication of the rights of the original parties." Report of Special Master on Motion of Robert J. Foley for Leave to Intervene, June 8, 1977, *South Dakota v. Nebraska*, No. 72, Original at 3. The Supreme Court overruled exceptions to this recommendation and granted the motions for leave to intervene. *South Dakota v. Nebraska*, 434 U.S. 948 (1977).

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requirement has been developed to preserve the limitations upon diversity jurisdiction applicable to United States district courts. As Professors Wright and Miller explain, "[t]he rule of complete diversity would be virtually obliterated, and the federal courts would be burdened with the decision of many matters that are properly the business of the state courts, if so tenuous a relationship as the existence of a common question of fact or law were enough to dispense with ordinary requirements of jurisdiction and permit litigants to have their independent claims or defenses tried in federal court though, absent intervention, they would not have been able to do so. . . . [T]o permit this would allow an unjustifiable expansion of federal jurisdiction." 7A C. Wright & A. Miller, *Federal Practice and Procedure* § 1917, at 593, 596 (1972). This concern is simply inapposite where a non-sovereign litigant seeks to intervene in an original jurisdiction action to litigate or defend the identical claims as a sovereign party. Even if a non-sovereign is permitted to intervene, the purpose underlying original jurisdiction where two sovereigns are involved remains intact. Such a non-sovereign intervenor works no expansion of the Court's original jurisdiction, a jurisdiction that it remains powerless to invoke in the first instance. *Cf. Arizona v. California*, 460 U.S. at 614 (Indian Tribes' efforts to intervene, without asserting new claims or issues, does not enlarge Supreme Court's judicial power over the controversy).

Rather than rigidly imposing the Federal Rules of Civil Procedure where they may be inappropriate, the Court has adapted those rules to conform to the ends of justice in its original jurisdiction cases. Thus, in *Maryland v. Louisiana*, 451 U.S. 725 (1981), the Court adopted the Special Master's suggestion that 17 private pipeline companies be permitted to intervene in a dispute over the constitutionality of a tax on natural gas. Instead of engaging in an inquiry into the adequacy of the representation of the private intervenors' interests by the sovereign parties, the Court simply held: "those companies have a direct stake in this controversy and *in the interest of a full exposition of the issues*, we accept the Special Master's recommendation that the pipeline companies be permitted to intervene, noting that it is not unusual to permit intervention of private parties in original actions." *Id.* at 745 n.21 (emphasis supplied).

Thus, where, as here, both the ends of justice and the convenience of the Court would be served by permitting the intervention of the NGA, a non-sovereign party, no rigid rules either of common law or of civil procedure should be allowed to tie the Court's hands. *Arizona v. California*, 460 U.S. at 614-15; *Ohio v. Kentucky*, 410 U.S. 641, 644 (1973); *Utah v. United States*, 394 U.S. 89, 95 & n.5 (1969). As Chief Justice Taney declared in an early original jurisdiction proceeding, it is

> the duty of the court to mold its proceedings for itself, in a manner that would best attain the ends of justice, and enable it to exercise conveniently the power conferred. And in doing this, it [is] without doubt one of its first objects to disengage them from all unnecessary technicalities and niceties, and to conduct the proceedings in the simplest form in which the ends of justice could be attained.

Florida v. Georgia, 58 U.S. (17 How.) 478, 492 (1854).

RECOMMENDATIONS

It is *RECOMMENDED* that the motion for leave to intervene of NGA be *GRANTED*, on the conditions herein specified.

As stated at the outset, the Special Master, with the concurrence of the parties, recommends that the Court defer review of these recommendations until the conclusion of the case and the submission of the final Report, reserving to the parties the right to file exceptions thereto at that time if so advised.

Respectfully submitted,

SAMUEL J. ROBERTS
Special Master
Court House
Erie, Pennsylvania 16501

November 16, 1984

No. 94, Original (2)

In the Supreme Court of the United States

OCTOBER TERM, 1984

STATE OF SOUTH CAROLINA, PLAINTIFF, AND NATIONAL GOVERNORS' ASSOCIATION, PLAINTIFF IN INTERVENTION

v.

JAMES A. BAKER III, SECRETARY OF THE TREASURY OF THE UNITED STATES OF AMERICA

ON BILL OF COMPLAINT

ANSWER TO COMPLAINT IN INTERVENTION

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In the Supreme Court of the United States

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STATE OF SOUTH CAROLINA, PLAINTIFF, AND NATIONAL GOVERNORS' ASSOCIATION, PLAINTIFF IN INTERVENTION

v.

JAMES A. BAKER III, SECRETARY OF THE TREASURY OF THE UNITED STATES OF AMERICA

ON BILL OF COMPLAINT

ANSWER TO COMPLAINT IN INTERVENTION

Defendant James A. Baker III, Secretary of the Treasury of the United States of America, by and through his attorneys, answers and responds to the Complaint of the Plaintiff in Intervention as follows:

1. Defendant admits the allegation in paragraph 1.

2. Defendant admits that paragraph 2 describes the relief requested by the plaintiff in intervention, but denies that plaintiff is entitled to such relief.

3. Defendant admits the allegations in paragraph 3.

4. Defendant admits the allegations in the first sentence of paragraph 4. Defendant lacks knowledge or information sufficient to form a belief as to the accuracy of the allegation in the second sentence of paragraph 4. Defendant admits the allegation, in the third sentence of paragraph 4, that the

governmental entities whose chief executives are members of the NGA issue tax-exempt bonds, but denies that Section 310(b)(1) of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), 26 U.S.C. 103(j), imposes any financial costs, legal constraints, or other burdens upon those entities.

5. Paragraph 5 of the Complaint in Intervention incorporates by reference paragraphs 1 and 2 of the Complaint filed by South Carolina. Defendant herein incorporates by reference paragraphs 1 and 2 of his Answer to the latter Complaint.

6. Paragraph 6 of the Complaint in Intervention incorporates by reference paragraphs 5 through 8 of the Complaint filed by South Carolina. Defendant herein incorporates by reference paragraphs 5 through 8 of his Answer to the latter Complaint.

7. Defendant admits the allegations in the first two sentences of paragraph 7. Defendant lacks knowledge or information sufficient to form a belief as to the accuracy of the allegations in the remaining sentences of paragraph 7.

8. Defendant lacks knowledge or information sufficient to form a belief as to the accuracy of the allegations in the first four sentences of paragraph 8. Defendant denies the allegations in the last sentence of paragraph 8. By way of further response to those latter allegations, Defendant herein incorporates by reference the second paragraph of paragraph 8 of his Answer to South Carolina's complaint.

9. The first sentence of paragraph 9 sets forth a contention of law which does not require a response. However, defendant notes that this contention appears to be based upon an interpretation of *National League of Cities* v. *Usery*, 426 U.S. 833 (1976), which has been overruled. *Garcia* v. *San Antonio Metropolitan Transit Authority*,

No. 82-1913 (Feb. 19, 1985), slip op. 2, 28. Defendant denies the remaining allegations in paragraph 9.

10. Defendant denies the allegations in the first sentence of paragraph 10. Defendant admits the allegation, in the second sentence of paragraph 10, that the Constitution allocates certain responsibilities between the federal government and the States, but denies that Section 310(b)(1) of TEFRA in any way impairs the States' ability to discharge their responsibilities. Defendant lacks knowledge or information sufficient to form a belief as to the accuracy of the allegations in the third and fourth sentences of paragraph 10. Defendant denies the allegations in the last two sentences of paragraph 10.

11. The first two sentences of paragraph 11 set forth contentions of law which do not require a response. Defendant denies the allegations in the third and fourth sentences of paragraph 11. Defendant admits the allegation, in the fifth sentence of paragraph 11, that a State would probably have to pay a higher interest rate if it chose to issue taxable, rather than tax-exempt, bonds. Defendant denies the allegation in the last sentence of paragraph 11.

ADDITIONAL DEFENSE

By way of further response to the Complaint of the Plaintiff in Intervention, defendant herein incorporates by reference the Additional Defense set forth in his Answer to South Carolina's Complaint.

WHEREFORE, defendant respectfully requests that the relief sought in the Complaint in Intervention be denied and

that defendant be granted such additional relief as this Court deems proper and necessary.

Respectfully submitted.

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MARCH 1985

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(3)

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OCTOBER TERM, 1986

STATE OF SOUTH CAROLINA,
Plaintiff,

NATIONAL GOVERNORS' ASSOCIATION,
Plaintiff in Intervention,

v.

JAMES A. BAKER, III, SECRETARY OF THE TREASURY OF THE UNITED STATES OF AMERICA,
Defendant.

BRIEF OF THE GOVERNMENT FINANCE OFFICERS ASSOCIATION AS *AMICUS CURIAE* IN SUPPORT OF PLAINTIFFS

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QUESTION PRESENTED

Whether the penalty imposed on State and local governments under the Tax Equity and Fiscal Responsibility Act of 1982 for failure to issue their obligations in registered form, i.e., loss of exemption from Federal taxation of interest thereon, is beyond the power of the Congress and thereby unconstitutional.

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INTEREST OF THE AMICUS CURIAE

This brief is submitted on behalf of the Government Finance Officers Association ("GFOA"). The GFOA, formed in 1903, is a professional organization of State and local finance officers who are deeply involved in planning and financing governmental facilities throughout the nation. Over 8,300 members of GFOA are officials representing State and local governments exercising all degrees of political authority, in major urban areas as well as sparsely populated rural areas. The interests of the members of the GFOA are as diverse as the governments they represent but they are united in their belief that the doctrine of intergovernmental tax immunity is an essential element in assuring the continued ability of State and local governments to function effectively.

The GFOA's interest and concern about Federal interference with State and local government public purpose borrowing practices has been evidenced in Policy Statements of the GFOA adopted at its Annual Conferences. In numerous such statements, the GFOA has reaffirmed its belief in the doctrine of reciprocal immunity whereby just as the Federal government is immune from taxation by State governments so also are the States and their instrumentalities immune from taxation by the Federal government.

The GFOA is concerned that recent Congressional and judicial inroads on the doctrine of tax immunity go beyond legitimate Federal concerns and impair the right of States to determine their own affairs, govern their citizens and meet their governmental responsibilities through the issuance of tax-exempt debt.

One troubling portion of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") *inter alia*, is the provision that purports to hold interest on State and local government obligations to be subject to Federal income taxation for failure to issue such obligations in registered form. The GFOA vigorously assails the penalty of forfeiture of tax exemption because it violates the

historically established tax immunity of State and local government obligations. This penalty is a tax on the power of the States and their local governments to borrow money and, in the view of the GFOA, is repugnant to the Constitution. GFOA's brief discusses the impact of the Sixteenth Amendment upon the doctrine of intergovernmental tax immunity. It will be shown that the Amendment's legislative history and subsequent interpretations of this Court, did not alter, but instead specifically preserved the Constitutional tax immunity enjoyed by interest on State and local government obligations. It also discusses the GFOA position that subsequent actions, including acquiescence (if any occurred), may not change that interpretation.

STATEMENT OF THE CASE

On January 22, 1987, the Honorable Samuel J. Roberts, retired Chief Justice of the Supreme Court of the State of Pennsylvania, acting as a Special Master pursuant to order of the Supreme Court of the United States,[1] delivered to the Court a Report of Special Master, including factual findings and legal analysis[2] in the matter of *South Carolina* v. *Regan*.[3]

In such case, the State of South Carolina, the National Governors' Association and various *amici* challenge the constitutionality of Section 310(b)(1) of the Tax Equity and Fiscal Responsibility Act of 1982[4] which

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[1] *South Carolina* v. *Regan*, 466 U.S. 948 (1984). On February 22, 1984 the Supreme Court granted the motion of the State of South Carolina to file an original complaint against the Secretary of the Treasury in such Court, 465 U.S. 367 (1984).

[2] Report of the Special Master, hereinafter cited as "Special Master's Report".

[3] 465 U.S. 367 (1984), No. 94, Original.

[4] *See* Tax Equity & Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 310(b)(1), 96 Stat. 324, 596 (1982) [hereinafter cited as TEFRA] which amended certain provisions of the Internal Revenue Code of 1954.

requires that in order for interest paid on an obligation to be eligible for exemption from Federal income taxation under the Internal Revenue Code, the obligation must be in fully registered form.[5] South Carolina and its fellow States maintain that this requirement is an unconstitutional infringement of their right to borrow freely,[6] a right reserved to the States in the Tenth Amendment of the United States Constitution.[7] The Special Master's Report may be read to support two legal propositions[8] which the GFOA believes to be fallacious. The first proposition, which the Solicitor General advocated, is that the history involved in the enactment and ratification of the Sixteenth Amendment[9] is presently irrelevant.[10] We believe such proposition in addition to being wrong does disservice to our constitutional system.

The second proposition inferred from the Special Master's Report is that the fundamental law of the land may be changed by a course of dealings or acquiescence.[11] We believe that this concept of acquiescence or "estoppel" has recently been rejected by this Court in circumstances where the factual determination of acquiescence between the executive and legislative branches of the Federal government was patently clear[12] and as such

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[5] Special Master's Report, p. 2.

[6] *Id.* at 2, 89.

[7] U.S. Const. amend. X. The tenth amendment provides: "The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people."

[8] Special Master's Report, p. 163, fn. 463 and pp. 135-137.

[9] See discussion *infra*.

[10] Special Master's Report, p. 163, fn. 463.

[11] Special Master's Report, pp. 135-137.

[12] *Immigration and Naturalization Service* v. *Chadha*, 462 U.S. 919 (1983) and *Charles A. Bowsher, Comptroller General of the United States* v. *Mike Synar, Member of Congress*, 478 U.S. ——, 92 L.Ed.2d 583 (1986).

this proposition is not only legally flawed but also historically inaccurate.

Finally, these propositions if adopted, even inferentially, by the Court can only serve to undermine the dependability of the amendment process, which Benjamin Franklin cited as a keystone in our governmental system due to our fallibility,[13] by its apparent wholesale rejection of reasonable reliance on statements and interpretations offered by competent parties during the amendment process.

Subsequent to the Court's determination to exercise jurisdiction in the *South Carolina* case, the Court issued its decision in *Garcia* v. *San Antonio Metropolitan Transit Authority*.[14] Although the GFOA agrees with the Administration[15] and the dissenting Justices in *Garcia* that such decision was overly-broad and should be subject to review, we do not believe that the exercise of Congress' power under the Commerce Clause has any particular relevance in the instant case. It is undisputed that the Federal government, if it so desires, can allocate to itself exclusive authority to regulate interstate commerce. However, the power to tax is the exclusive domain of neither the States nor the Federal government.

Notwithstanding the decision in *Garcia*, however, it should be noted that in determining to exercise original jurisdiction in the *South Carolina* case, four of the Justices (Chief Justice Burger, Justices Brennan, Marshall and White) found it to be unquestionable that "the manner in which a State may exercise its borrowing power is a question that is of vital importance to all 50

[13] Remarks at the Constitutional Convention, read Monday, September 17, 1787. *Papers of James Madison, His Reports of Debates in the Federal Convention*, Volume III, p. 1596.

[14] 469 U.S. 528 (1985).

[15] See *The Status of Federalism in America: A Report of the Working Group on Federalism of the Domestic Policy Council November 1986.*

States",[16] that Justice Blackmun found the issue presented to be a "substantial one" and "of concern to a number of States"[17] and an additional three Justices (O'Connor, Powell and Rehnquist) found the authority claimed by South Carolina to have "significant historical basis" and the injury alleged "could deprive it of a meaningful political choice".[18]

One of the Justices, however, Justice Stevens, dissenting in part, observed "there is simply no merit to the claim the State has advanced"[19] and "[a] long line of cases plainly forecloses the first claim; the other two are frivolous".[20] Alarmingly, certain Federal courts have focused on the dissent of Justice Stevens to find ". . . the Supreme Court has continued to narrow if not reject immunity doctrine [*sic*]."[21]

The Court may, of course, accept or reject all or any part of the Special Master's factual and legal analysis and recommendation. If the Special Master's factual determination is adopted by the Court, GFOA believes that whether this is the proper case in which to resolve complicated constitutional issues regarding our historic federal system should itself be the subject of careful consideration. The GFOA respectfully suggests that if the Supreme Court does decide to adopt the recommendation as to judgment it do so clearly and state the reason therefor lest its action create more uncertainty as to the

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[16] 465 U.S. 367, 382 (1984).

[17] *Id.* at 384.

[18] *Id.* at 401.

[19] *Id.* at 403.

[20] *Id.* at 404.

[21] *Shapiro* v. *Baker*, 646 F. Supp. 1127, 1131 (D.N.J., 1986). See also *Harrison J. Goldin, Comptroller of the City of New York* v. *James Baker, Secretary of the Treasury of the United States*, United States Court of Appeals, Second Circuit (1987), 809 F.2d 187, 189 and 191 and *Boli* v. *United States*, United States Court of Claims, Wash., D.C., No. 151-86T, February 11, 1987.

status of the States in the Federal system. The need for clarity is particularly important in view of certain lower courts' reactions to Justice Stevens' opinion. The long-standing protection of the States from Federal taxation that permeates our laws, our court decisions and our constitutional framework and the historical development of this immunity which is rooted in the very foundation of the Federal system cannot and should not be dismissed lightly.

SUMMARY OF ARGUMENT

The Court in the *Pollock*[22] decisions unanimously determined that the Congress may not constitutionally tax the interest on State and local government obligations. The Sixteenth Amendment did not change and was not intended to change the law as stated in the *Pollock* decisions in this particular area. Subsequent actions which fall short of a constitutional amendment even including "acquiescence", if any occurred may not change the law as so stated.

ARGUMENT

I. THE COURT IN THE POLLOCK DECISIONS UNANIMOUSLY DETERMINED THAT THE CONGRESS MAY NOT CONSTITUTIONALLY TAX THE INTEREST ON STATE AND LOCAL GOVERNMENT OBLIGATIONS.

The GFOA is in general agreement with the Special Master's Report insofar as it sets forth the history of reciprocal immunity through *Pollock v. Farmer's Loan & Trust Co.*[23] In such case the Court struck down as unconstitutional an 1894 Act of Congress providing for a levy of taxes (i) which to the extent they constituted a direct tax were not apportioned among the States in accordance with Article I, Section 2 of the Constitution,[24]

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[22] 157 U.S. 429, on rehearing 158 U.S. 601 (1895).

[23] 157 U.S. 429, on rehearing 158 U.S. 601 (1895).

[24] 157 U.S. 429 at 432. Article I, Section 2, clause 3 of the Constitution provides in part: "Representatives and direct taxes shall be apportioned among the several States. . . ."

(ii) which to the extent not direct, were not uniform in accordance with Article I, Section 8 of the Constitution,[25] and (iii) which purported to tax interest on the obligations of States and their instrumentalities.[26] As to this latter point, we would reiterate the words of the Court therein:

> "We have unanimously held in this case that, so far as this law operates on the receipts from municipal bonds, it cannot be sustained, because it is a tax on the power of the States, and on their instrumentalities to borrow money, and consequently repugnant to the Constitution". [27]

Likewise, the statement of Justice Brown, in dissent:

> "The tax upon the income of municipal bonds falls obviously with the other category, of an indirect tax upon something which Congress has no right to tax at all, and hence is invalid." [28]

II. THE SIXTEENTH AMENDMENT DID NOT CHANGE AND WAS NOT INTENDED TO CHANGE THE LAW AS STATED IN THE POLLOCK DECISIONS IN THIS AREA.

A reaction to the main holding of *Pollock* [29] resulted in President Taft seeking a proposed constitutional amendment which would confer upon the national government the power to levy on income a tax "without apportion-

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[25] 157 U.S. 429, at 432. Article I, Section 8, clause 1 of the Constitution provides: "The Congress shall have Power To lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defence and general Welfare of the United States; but all Duties, Imposts and Excises shall be uniform throughout the United States." On rehearing, the Court determined that taxes on rents or income from real property were direct taxes subject to the rule of apportionment, 158 U.S. 601, 637 (1895).

[26] 157 U.S. 429, 584, 601-602, 652, 653, on rehearing 158 U.S. 601, 693 (1895).

[27] 158 U.S. 601, 630.

[28] *Id.* at 693.

[29] 158 U.S. 601 (1895).

ment among the States in proportion to population".[30] President Taft recommended adoption of the amendment since "[f]or the Congress to assume that the [Supreme C]ourt will reverse itself, and to enact legislation on such an assumption will not strengthen popular confidence in the stability of judicial construction of the Constitution".[31] The Congress passed the proposed amendment and sent it to the States for ratification.

The spectre of taxation of the States' debt obligations was raised (allegedly as an attempt to derail the ratification process[32]) by Governor Charles Evans Hughes of New York in an address to the State legislature.[33] Proponents of the amendment in the Congress reacted immediately, especially in the Senate, and charged that Gov-

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[30] 44 Cong. Rec. 3344, 1548, 1568-69, 3377 (1909). The Senate Finance Committee reported the proposal in the form subsequently adopted as the Sixteenth Amendment: "[t]he Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration." *Id.* at 3900. See also 45 Cong. Rec. 1113, January 27, 1910, in which Representative Hull appears to question President Taft's sincerity. *Id.*

[31] 44 Cong. Rec. 1548, 1568-69, 3377 (1909).

[32] See statement of Senator Borah, 45 Cong. Rec. 1698, February 10, 1910 and of Representative Cordell Hull, 45 Cong. Rec. 1113-1114, January 27, 1910.

[33] Message to the New York State Legislature (Jan. 5, 1910). See the text of the Hughes' statement in Appendix A hereto. The New York Times reported the Hughes' statement, Jan. 6, 1910, at 2, col. 4, and simultaneously issued an editorial urging defeat of the ratification of the amendment based on the Governor's criticism. *Id.* at 8, col. 1. Responses of other governors to these observations were then published including those of Governor Gilchrist of Florida who supported ratification in this expressed belief that the notions of self-preservation of the States and freedom from Federal taxation was implicit in any Federal tax action and hence could not be affected by the amendment and Governor Vessey of South Dakota who acknowledged that if the Hughes' position were correct, he would oppose ratification. N.Y. Times, Jan. 7, 1910, at 3, col. 3.

ernor Hughes' warning was unfounded or alarmist.[34] The Senator from New York, Senator Elihu Root, directed his comments to the members of that State's legislature.[35]

Representative Cordell Hull speaking in the House of Representatives described the Hughes' objection as "unsupported by reason or experience".[36]

Governor Fort of New Jersey, in submitting the amendment to the Legislature of that State, took issue with Governor Hughes, stating "[n]or am I inclined to accept the statement that the Supreme Court of the United States might construe the words 'from whatever source derived' as found in the pending amendment as justifying the taxing of the securities of any other taxing power." [37]

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[34] See comments of Senator Borah, 45 Cong. Rec. 1694-98 (1910). Senators Borah's and Root's comments on this issue were also noted by The New York Times, *see* Feb. 11, 1910, at 1, col. 4; Mar. 1, 1910, at 4, cols. 2 and 3, and the newspaper reported that Senator Borah's speech was favorably received:

> When Mr. Borah concluded his argument that it was inherent in the nature of the independent sovereignties of the (states) and the Nation, that neither could tax the means of support of the other, many Senators, including Mr. Bailey of Texas, Mr. Heyburn of Idaho, Mr. Bacon of Georgia, and Mr. Smoot of Utah, crowded up to congratulate him, and all of them indorsed heartily the position he had assumed in regard to Gov. Hughes' attack on the Amendment as it stood.

N.Y. Times, Feb. 11, 1910, at 1, col. 4.

[35] Senator Root answered in both the Senate, and by letter to the Legislature. 45 Cong. Rec. 2539 (1910). For the text of Senator Root's letter see Appendix B hereto. Prior to adoption of the Seventeenth Amendment, members of the United States Senate were appointed by their respective State legislatures and were responsive to them.

[36] 45 Cong. Rec. 1114, January 27, 1910.

[37] Message to the New Jersey Legislature (Feb. 7, 1910). Senator Brown retorted: "It cheers our hearts to read in the press that President Taft agrees with the governor of New Jersey, who, in a message to his legislature February 7 and since the New York message was transmitted, took immediate and direct issue with the governor of New York." 45 Cong. Rec. 2245 (1910).

Senator Brown, a sponsor of the resolution, although not disposed to oppose the taxing of State and local government securities, nonetheless expressed surprise at Governor Hughes' comments, stating:

> The amendment does not alter or modify the relation today existing between the States and the Federal Government. That relation will remain the same under the amendment as it is today without the amendment. It is conceded by all that the Government cannot under the present Constitution tax state securities or state instrumentalities.[38]

Significantly, *no member of the Congress supported the proposition that the amendment would permit the taxation of the interest on State debt obligations.*[39] The Hughes' furor died down and the proposal was ratified as the Sixteenth Amendment to the Constitution.[40]

The Special Master accepts this analysis and notes that ". . . the principal sponsors of the Sixteenth Amendment took pains to assure the Congress that passage of the Six-

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[38] 45 Cong. Rec. 2245-2246 (1910). Senator Brown implied that if Hughes were correct the resolution would not have passed the Congress so easily.

[39] In 1940, in comments accompanying a revenue bill which provided for Federal taxation of the interest on municipal debt, Senator Brown of Michigan felt it important to revisit the Hughes furor and sought to rebut the allegations that Hughes' actions were a ploy to defeat the Sixteenth Amendment, 86 Cong. Rec. 12291-12304, 12293 (September 19, 1940) in order to postulate an argument that ratification took place after consideration and acceptance of the Hughes position. This argument was joined strongly by Senator Austin, *Id.* at 12294, including insertion of a report recording certain governors' reactions to the Hughes' statements, *Id.* at 12297. The text of such report is included as Appendix C hereto.

Subsequent decisions of Governor Hughes while serving as Chief Justice of the Supreme Court indicate that he was satisfied with the Senatorial defense of the intent of the amendment. See *Helvering* v. *Mountain Producers Corp.*, 303 U.S. 376, 386 (1938); *James* v. *Dravo Contracting Co.*, 302 U.S. 134, 154 (1937) and *Willcuts* v. *Bunn*, 282 U.S. 216 (1930).

[40] See proclamation of the Secretary of State, February 25, 1913.

teenth Amendment would not, in and of itself, authorize Federal taxation of municipal bonds." [41]

However, the Special Master posits that the understanding of the sponsors offers no support for South Carolina's position insofar as "the Sixteenth Amendment did not purport to address the scope of the Federal taxing power as applied to activities of the States".[42] The GFOA believes that the Special Master erred in his assessment of the significance of the sponsors' understanding.

Much Congressional debate ensued following enactment of the Sixteenth Amendment. In introducing the first income tax statute adopted pursuant to such amendment, Representative Cordell Hull noted that the statute particularly provided that interest on State obligations was specifically excluded from the definition of income so as not to raise a constitutional question.[43]

As the interests and economic needs of the Federal government grew, several unsuccessful attempts were made to legislate such taxation. In 1918, under questioning from a sympathetic Senator, Mr. Smith of Arizona, Senator Thomas presented a lengthy review of the concurrent and subsequent congressional and judicial interpretations of the Sixteenth Amendment, particularly the exchange between Governor Hughes and Senator Root, commenting:

> Upon the strength and under the interpretation outlined in [the Root letter to the New York State Leg-

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[41] Special Master's Report, pp. 162-163.

[42] Special Masters Report, p. 163, fn. 463. The Circuit Court of Appeals for the Second Circuit, incorrectly, in the view of the GFOA, disagrees with the Special Master on this point: "In *Pollock*, the Supreme Court held a Federal statute imposing a tax on income from municipal bonds to be unconstitutional. . . . The passage of the Sixteenth Amendment to the Constitution in 1913 and numerous Supreme Court decisions since that time have cast doubt on the vitality of *Pollock*". *Goldin* v. *Baker*, 809 F.2d 187, 189 (1987).

[43] 50 Cong. Rec. 508 (1913). For a related discussion see the Appendix D hereto.

islature], the General Assemblies of the States of New York and New Jersey finally ratified the amendment. I think I am safe in asserting that such was the understanding of the legislatures of the other ratifying States. I affirm that it could not have been ratified at all had it been supposed to clothe the Federal Government with power to impair the integrity and undermine the structure of the States through the power of unlimited taxation. Nothing in the debates of the Congress nor in the comments of the press during the period of its consideration—nothing, indeed, until the message of Gov. Hughes appeared—was said or written which intimated that the representatives of the people in the Congress of the United States were subjecting their States, the agencies and instrumentalities thereof, to the taxing power of the Nation.[44]

A similar attempt as an "emergency revenue measure" during World War I [45] was met by a strong rebuttal from Senator Borah:

I think, however, that while it seems we are engaged in these days in an unconscious, if not a conscious, movement to destroy the sovereignty of the States, we may pause before taking the final step to consider

[44] 56 Cong. Rec. 10,631. For a related discussion, see Appendix E. Senator Knox answered the remarks of Senator Thomas, noting "the observations which I intend to make have, in my judgment, a very direct and immediate effect upon the winning of this war . . . . [T]he exigencies of the present situation are so grave that if Congress can constitutionally impose the tax it should do so." 56 Cong. Rec. 10,933 (1918).

Senator Knox then inserted into the record the extensive response made by Senator Borah to Governor Hughes, stating that it "was addressed at that time particularly to the proposition that the sixteenth amendment did not affect the question, and for myself I think the Senator from Idaho conclusively maintained that proposition." *Id.*

[45] 56 Cong. Rec. 10,941 (1918). Senator Borah rose to answer Senator Knox and observed that the taxes struck down in *The Collector* v. *Day*, 78 U.S. (11 Wall.) 113 (1870) and *Lane County* v. *Oregon*, 74 U.S. (7 Wall.) 71 (1868), were both enacted as wartime measures.

> whether it is wise to go all the way. I do not believe a few million dollars is any price to put up against the Federal system which was originally constructed by the fathers. If we take away the rights of the State to control the franchise, and then go further and lay taxes upon the very instrumentalities of the State governments, certainly we shall have concluded that the States as sovereign entities are no longer essential. That may be the doctrine which we are to accept, but under no conceivable circumstances shall I ever subscribe to it. I repeat, as I have said elsewhere, you can have no great Federal Union without great and powerful Commonwealths upon which the Federal Government may rest.[46]

Subsequently, the Congress failed to pass a constitutional amendment which would have authorized prospective taxation.[47]

Proposals to tax such interest were made several times and extensive and objectively inconclusive hearings were held as to whether a constitutional question was involved with the consensus at such hearings as hereinafter set forth being that a substantial constitutional impediment prohibited such taxation.

At one such hearing, a letter from Secretary of the Treasury Andrew W. Mellon was read into the record, stating that the Secretary assumed it to be clear under

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[46] 56 Cong. Rec. 10,941 (1918). On October 10, 1918, Senator Kellogg offered extensive rebuttal to the comments of Senator Knox, echoing the remarks of Senators Thomas and Borah. 56 Cong. Rec. 11,181-87 (1918). For other contemporaneous discussions, see H.R. Rep. No. 767, 65th Cong., 2d Sess. 9 (1918); S. Rep. No. 617, 65th Cong., 3rd Sess. 6 (1918).

[47] *Hearings before the Comm. on Ways and Means, House of Representatives on Tax-Exempt Securities*, H.R.J. Res. 102, 67th Cong., 1st Sess. (1922) [hereinafter cited as *1922 Hearings*]. Several resolutions were introduced in Congress for the stated purpose of amending the Constitution so as to permit the prospective taxation of interest on municipal securities. Extensive hearings (there are 196 pages of testimony) were held on such resolutions.

judicial interpretation that the Sixteenth Amendment does not permit the Federal Government to tax income derived from State or local government securities,[48] and that the effective means of restricting further issues of tax-exempt securities by State or municipal government would be by constitutional amendment.[49]

On June 6, 1924, the Senate received a report of the Chairman of the Federal Trade Commission regarding taxation and tax-exempt income.[50] In response to the question "Is Congress obliged to exempt State bonds?" the report stated that the income tax acts exempt the obligations of the States, Territories, possessions, and their political subdivisions. However, such response questioned whether, even without this provision in the Federal income tax acts, the interest from the securities of the States or their political divisions would not be held tax exempt on constitutional considerations.[51] Citing to *Pollock v. Farmer's Loan & Trust Co.*[52] the report interpreted the position of the Supreme Court as holding that

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[48] *See 1922 Hearings, supra* note 47, at 11-12. Secretary Mellon endorsed the intent of one of the resolutions, which it is noted by Representative McFadden "was drawn by the Treasury Department." *Id.* at 11.

[49] *Id.* at 12. In February, 1923, the Senate conducted hearings on H.R.J. Res. 314 which had passed the House of Representatives on January 23, 1923. *Tax-Exempt Securities, Hearings before a Subcomm. of the Senate Comm. on the Judiciary on H.R.J. Res. 314*, 67th Cong., 2d Sess. (1923) [hereinafter cited as *1923 Hearings*]. H.R.J. Res. 314 provided in part that "[t]he United States shall have power to lay and collect taxes on income derived from securities issued, after the ratification of this article, by or under the authority of any State . . . ." *1923 Hearings, supra*, at 1. The Senate never acted on the resolution and it was reintroduced in the House on January 10, 1924. After being debated again, it was rejected on February 8, 1924, by a vote of 247-133.

[50] S. Doc. No. 148, 68th Cong., 1st Sess. (1923) [hereinafter cited as *FTC Report*]. The request of the Senate was made in Senate Resolution 451, adopted February 28, 1923.

[51] *FTC Report* at 2.

[52] 157 U.S. 429, *on rehearing*, 158 U.S. 601 (1895).

by constitutional implications neither the State governments nor the Federal government has the power to tax the instrumentalities of the other.[53] The Commission report concluded that the Sixteenth Amendment did not extend the taxing powers of Congress to include interest paid on State obligations.[54]

The Congress held additional hearings on reciprocal immunity[55] with the result in 1924 that a majority of the House Ways and Means Committee determined that a constitutional amendment was a prerequisite to Federal taxation of municipal securities.[56]

In 1936, the Congressional Joint Committee on Internal Revenue Taxation received for information and discussion purposes a report which concluded that the Federal government, notwithstanding the Sixteenth Amendment,

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[53] *FTC Report*, at 2.

[54] *Id.* at 2.

[55] Prior to the defeat of the re-introduced H.J. Res. 314, *see supra* note 49, the Committee on Ways and Means referred to the House a report on Tax-Exempt Securities, H.R. Rep. No. 30, 68th Cong., 1st Sess. (1924) [hereinafter cited as *1924 House Report*], which stated:

> The amendment proposed strikes at an evil in our system of taxation which is already great and, if unchecked, will grow to such magnitude as to even threaten the existence of our institutions. The Constitution of the United States, as it now stands, not only permits the issuance of tax-exempt securities by either the Federal or State Governments but absolutely prevents the Federal Government on the one hand from levying income tax on securities issued by the several States, and the States on the other hand from levying an income tax on the securities issued by the Federal Government.

1924 *House Report*, *supra*, at 1.

[56] Tax Exempt Securities, Report to accompany H.J. Res. 136, 68th Cong., 1st Sess., Rept. No. 30 (1924), pp. 6-9. For a collection of law articles, opinions and letters in respect of the power of the Congress to tax interest from municipal bonds, see *Tax-Exempt Securities*, printed for the use of the Senate Committee on Finance, March 26, 1924.

had no power to tax the income of State securities.[57] In 1937, the Subcommittee of the Committee on the Judiciary of the United States Senate issued a report, regarding the taxation of interest on municipal securities. The report contained a response from Mr. Roswell Magill, Acting Secretary of the Treasury, which stated:

> If this result [taxation of municipal securities] could be achieved by legislation alone, the solution of the problem of the tax-exempt security would be relatively simple. Unfortunately, it seems perfectly clear under the decisions of the courts that the desired result cannot be attained in the case of State and municipal issues by any action short of the submission and ratification by the States of a constitutional amendment.[58]

In *Brushaber* v. *Union Pacific Railroad Co.*, the Supreme Court accepted Senator Brown's conclusion referenced earlier, noting "the *whole* purpose of the Amendment was to relieve all income taxes when imposed from apportionment from a consideration of the source whence the income was derived . . ., and not to change the existing interpretation except to the extent necessary to accomplish the result intended . . . ."[59] (emphasis added)

In cases subsequent to enactment of the Sixteenth Amendment which reaffirm the existence of and yet limit the scope of immunity, the question of the effect on State

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[57] *The Taxing Power of the Federal and State Governments* [hereinafter cited as *1936 Report*]. Under the joint captions "(J) State Securities (1) Development of Doctrine of State Immunity," the Report unequivocally states: "[t]he Federal Government has no power to tax the obligations on the interest therefrom of a State or political subdivision," *1936 Report*, at 60, and "[t]hat the Federal Government has no power to tax the income of State securities, notwithstanding the provisions of the sixteenth amendment, is further established in the case of *National Life Insurance Company* v. *United States*." *1936 Report*, at 62.

[58] Report of the Subcommittee of the Committee on the Judiciary of the United States Senate on S.J. Res. 5 and S.J. Res. 154, at 4, 1937.

[59] *Brushaber* v. *Union Pac. R.R. Co.*, 240 U.S. 1, 18-19 (1916).

activity was considered and generally distinguished from any *prior* interference with the borrowing power. For instance, in *Willcuts* v. *Bunn*,[60] Chief Justice Hughes stated:

> [I]t does not follow, because a tax on the interest payable on state and municipal bonds is a tax on the bonds and therefore forbidden, that the Congress cannot impose a non-discriminatory excise tax upon the profits derived from the sale of such bonds. The sale of the bonds by their owners, after they have been issued by the State or municipality, is a transaction distinct from the contracts made from the government in the bonds themselves . . . ." [61]

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[60] 282 U.S. 216, 226 (1930).

[61] *Id.* at 227. The holding in *Willcuts* is consistent with determinations of the Court in *National Life Ins. Co.* v. *United States*, 277 U.S. 508 (1928), and *United States* v. *Atlas Ins. Co.*, 381 U.S. 233 (1965). In *National Life*, the Court struck down a provision of the Federal income tax law which permitted insurance companies to exclude municipal bond interest from gross income but required that the amount of such interest be deducted also from the allowable deduction with the effect that the tax paid was the same as if all the income were taxable. The Court ruled that "[o]ne may not be subjected to greater burdens upon his taxable property solely because he owns some that is free". 277 U.S. at 519. In *Atlas*, the Court upheld a requirement of the Federal income tax law that required insurance companies to prorate exempt interest between the company and its policyholders. The Court noted, "[i]t is apparent from the face of the Act that . . . Congress did not consider the application of the formula in the usual case to lay a tax on exempt interest . . ." and, "[a]s time and again stated in the Committee Report and by those who presented the bill on the floor of the Senate, the purpose of the [proration] formula provided by the Senate was to avoid taxing exempt interest". 381 U.S. at 240-41. The Court further added that the Department of the Treasury said in a letter that the formula did not place a tax on exempt interest but that an exception had been worked into the bill in case of such eventuality. 381 U.S. at 241 n.12. See also the dialogue between then Senate Finance Committee Chairman Harry F. Byrd and Senator Strom Thurmond, 105 Cong. Rec. 9400-01 (June 10, 1959) (discussion of proration formula and reiteration of immunity doctrine).

Similarly, in *James* v. *Dravo Contracting Co.*, Chief Justice Hughes noted:

> [t]here is no ineluctable logic which makes the doctrine of immunity with respect to government bonds applicable to the earnings of an independent contractor rendering services to the Government. That doctrine recognizes the direct effect of a tax which would "operate on the power to borrow before it is exercised" . . . and which would directly affect the Government's obligations as a continuing security. Vital considerations are there involved respecting the permanent relations of the Government to investors in its securities and its ability to maintain its credit,—considerations which are not found in connection with contracts made from time to time for the services of independent contractors.[62]

In *Helvering* v. *Gerhardt*,[63] Justice Stone, writing for six members of the Court, including Justice Hughes, found the salaries of a state instrumentality employee to be subject to Federal taxation,[64] and distinguished the holding from an attempt to tax the income received by a private investor from State bonds, and thus threaten to impair the borrowing power of the State.[65]

Shortly after *Gerhardt*,[66] the Court determined in *Graves* v. *O'Keefe*[67] that the salaries of Federal employ-

[62] 302 U.S. at 152-53 (quoting from *Pollock* v. *Farmers' Loan and Trust Co.*, 157 U.S. 429 (1895)).

[63] 304 U.S. 405 (1938).

[64] *Id.* at 424. The Court found the salaries of a construction engineer and two assistant general managers of the Port of New York Authority are subject to Federal income taxation. The Port of New York Authority, now the Port Authority of New York and New Jersey is a bi-state corporation created by compact between the States of New York and New Jersey and is consented to by the Congress.

[65] *Id.* at 417.

[66] 304 U.S. 405 (1938).

[67] 306 U.S. 466 (1939).

ees could be subject to state income taxation.[68] The decision in *Graves* (which effectively resulted in State and local government salaries and Federal government salaries being treated the same from a reciprocal immunity standpoint) overruled two prior decisions of the Court.[69] Not only did the Court not overrule *Pollock*, it observed:

> The theory of the tax immunity of either government, state or national, and its instrumentalities, from taxation by the other, has been rested upon an implied limitation on the taxation power of each, such as to forestall undue interference, through the exercise of that power, with the governmental activities of the other.[70]

In a series of lectures delivered in 1951 former, Supreme Court Justice Roberts observed:

> It appears always to have been conceded that a tax laid directly on bonds of a state is invalid. The principal has been extended to a federal income tax applied to interest on municipal bonds.[71]

After the determination of the Court that salaries of State and Federal employees were not immune from taxation,[72] test litigation on the question of State obligations was advocated and, in at least two instances, commenced

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[68] *Id.* at 486.

[69] *Id.* at 486. *The Collector* v. *Day*, 78 U.S. (11 Wall.) 113 (1870); *New York ex rel. Rogers* v. *Graves*, 299 U.S. 401 (1937).

[70] *Id.* at 477-78.

[71] O.J. Roberts, *The Court and the Constitution*, The Oliver Wendell Holmes Lectures p. 23 (1951). In such lectures, Justice Roberts questioned Justice Holmes' response to Chief Justice Marshall, i.e., "[t]he power to tax is not the power to destroy while this court sits". *Panhandle Oil Co.* v. *Knox*, 277 U.S. 218 (1928). He asserts that if Holmes' statement means that "one sovereign is free to tax the instrumentalities of the other up to the point where nine justices or a majority of them pragmatically declare the burden has become, in their opinion, too heavy . . . [t]his could only mean that the Court is a super-legislature"., *id.* at 12-13.

[72] *Helvering* v. *Gerhardt*, 304 U.S. 405 (1938); *Graves* v. *O'Keefe*, 306 U.S. 466 (1939).

with embarrassing results for the Treasury Department.[73] Of historical interest is the presence in one such instance of earlier opinions given as an attorney by Charles Evans Hughes.[74]

After *Graves* v. *O'Keefe* the tone of the 1939 congressional hearings became somewhat less definitive as to whether a constitutional amendment was necessary with the Bureau of Internal Revenue[75] more aggressive on the matter than the Justice Department.[76]

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[73] The two cases were *Commissioner of Internal Revenue* v. *Shamberg's Estate*, 144 F.2d 998 (2d Cir. 1944), and *Commissioner of Internal Revenue* v. *White's Estate*, 144 F.2d 1019 (2d Cir. 1944).

[74] Charles Evans Hughes issued an opinion in 1925 as to "the powers and immunities of the Port of New York Authority and the status of its bonds." Such opinion states:

> The *immunity* of the bonds from Federal taxation follows from the fact that, as already stated, the port authority is a public agency, a governmental instrumentality of the two States. . . . In this view, the bonds issued by the port authority will be on the same footing as state and municipal bonds issued for governmental purposes and are not subject to taxation by the Federal Government.
>
> The income of these bonds will be likewise free from Federal taxation for the reason that a tax upon the income of the bonds is in substance and in legal effect a tax upon the bonds themselves and *upon the borrowing power of the State confided to its instrumentality*.

Opinion of Charles Evans Hughes, Nov. 10, 1925 (emphasis added, citations omitted). Two significant points are to be noted in the opinion. One, the opinion referred to *immunity* from taxation, rather than exemption from taxation, under the contemporary Internal Revenue Code. Two, the decisions of that period determining the existence of such immunity and whether the obligations were validly issued by the State or its instrumentality as an exercise of the State's borrowing power were based on a reading of *State* rather than Federal law.

[75] See *Tax-Exempt Salaries, Hearings before the House Comm. on Ways and Means*, Statement of John P. Wenchel, Chief Counsel, Bureau of Internal Revenue, 76th Cong., 1st Sess. 65-67 (1939).

[76] See *Tax-Exempt Salaries Hearings Before the House Committee on Ways and Means*, Statement of James W. Morris, Assistant Attorney General, 76th Cong., 1st Sess. (1939), at 52.

Additional hearings and reports were conducted in 1940 [77] and on September 19, 1940, the Senate by a vote of 44 to 30 [78] effectively adopted a Minority Report which concluded ". . . [w]hether or not the supreme power to tax the States is the power to destroy them, it is most definitely and certainly the power to control them." [79] Numerous other instances of Congressional attention to this matter were evident during this period.[80]

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[77] *Taxation of Governmental Securities and Salaries, Report of the Special Comm. on Taxation of Governmental Securities and Salaries Pursuant to S. Res. 303 (75th Cong.)*, S. Rep. No. 2140, Part 1, Part 2, 76th Cong., 3d Sess. (1940) [hereinafter the "1940 Report"].

[78] 86 Cong. Rec. 12,291-12,304 (1940).

[79] Part 2 of the 1940 Report represented the views of the minority of the Special Committee on Taxation of Governmental Securities and Salaries [hereinafter cited as *Minority Report*]. The *Minority Report* attacked the proposal to tax the interest on State and local obligations as both unconstitutional and economically unsound, and additionally noted that the proposal was opposed on the constitutional basis by the 45 State Attorneys General. *Minority Report, supra*, at 1-2. It states emphatically:

> [I]t is difficult to believe that those who support this measure really appreciate the shocking political consequences of the method by which it is proposed to tax these securities. The enactment has been described as a simple statute, yet it necessarily asserts a supreme Federal power to tax the States themselves. The Department of Justice itself so describes the power claimed. Its argument encompasses an abandonment of the concept of this Government as a Federation of Independent States; it would subordinate the States to an all powerful central government. The proponents of the measure ignore these constitutional implications. But we submit that the power claimed opens a wide avenue to centralization. Whether or not the supreme power to tax the States is the power to destroy them, it is most definitely and certainly the power to control them.

Minority Report, supra, at 3.

[80] See, e.g., *Tax-Exempt Salaries*; *Hearings before the House Comm. on Ways and Means*, 76th Cong., 1st Sess. (1939); *House Comm. on Ways and Means*; *The Public Salary Tax Act of 1939, Report accompanying H.R. 3790*, H.R. Rep. No. 26, 76th Cong., 1st Sess. (1939); *Hearings on H.R. 3790 Before the Senate Comm.*

It should not be inferred from the foregoing matter that the Congress is oblivious to the constitutional argument. The Congressional Report accompanying the Tax Reform Act of 1969 noted:

> [T]here is a body of opinion to the effect that it would be unconstitutional for the Federal Government to tax interest from State and local governments. It is also maintained that the exemption is part of a Federal system of government under which the Federal Government does not infringe on the powers of the State and local governments. This position has been disputed, and many authorities have indicated that the Federal Government does have a constitutional right to tax the interest on State and local securities.[81]

Both the Congress and this Court have been mindful of similar constitutional restraints on Congressional action in regard to State and local government operations in establishing "uniform laws on the subject of Bankruptcies".[82] Even during the Depression, the bankruptcy

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on *Finance, An Act Relating to the Taxation of the Compensation of Public Official Employees*, 76th Cong., 1st Sess. (1939); *The Public Salary Tax Act of 1939, Report accompanying H.R. 3790, H.R. Rep. No. 112* 76th Cong., 1st Sess.; *State Taxation of Federal Employees, Opinions of the Supreme Court of the United States together with the concurring and dissenting opinions*, S. Doc. No. 55, 76th Cong., 1st Sess. (1939); *Taxation of the Compensation of Public Officers and Employees, Conference Report accompanying H.R. 3790*, H.R. Rep. No. 390, 76th Cong., 1st Sess. (1939); *Power of Congress to Tax the Interest from State and Local Securities and the Compensation of State and Local Employees, Report to the Joint Comm. on Internal Revenue Taxation by its staff pursuant to Section 1203, Revenue Act of 1926*, United States Government Printing Office, Washington, 1939; *Taxation of Governmental Securities and Salaries, Hearings Before the Senate Special Comm. on Taxation of Governmental Securities and Salaries, pursuant to S. Res. 303 (75th Cong.)* 76th Cong., 1st Sess. (1939); *Tax-Exempt Securities: Hearings before the House Comm. on Ways and Means, on Proposed Legislation Relating to Tax-Exempt Securities*, 76th Cong., 1st Sess. (1939).

[81] 1969 U.S. Code Cong. & Admin. News 1825-26.

[82] U.S. Constitution, Article 1, Section 8, clause 4.

courts were restrained from issuing "any order or decree . . . interfer[ing] with any of the political or governmental powers of the taxing district . . . necessary in the opinion of the judge for essential governmental purposes."[83] In *United States* v. *Bekins*[84] Solicitor General Jackson (subsequently Supreme Court Justice Jackson) argued that the powers of the Federal government under the bankruptcy provisions of the Constitution were more extensive than the Federal taxing power.

It should therefore be clear that if Congress lacks the power to regulate States or local governments (absent their consent) in matters related to bankruptcy it must lack the power to impose a tax on the interest on their obligations.

Solicitor General Jackson also noted that:

> Tax burdens, of course, are involuntary burdens and, as this Court has said, may be destructive. The power to tax may be the power to destroy, and *it may be laid upon a State as a State only when it has assumed that obligation. . . .*"[85] (emphasis added)

III. SUBSEQUENT ACTIONS WHICH FALL SHORT OF A CONSTITUTIONAL AMENDMENT, EVEN INCLUDING "ACQUIESCENCE", IF ANY OCCURRED, MAY NOT CHANGE THE LAW AS SO STATED.

The Special Master described recent Congressional activities as follows:

> Moreover, there is a history of Federal regulation in this field. Congress began regulating municipal industrial development bonds in 1968. Congressional regulation—extended in 1969 to municipal arbitrage financing practices—has entailed intricate and complex substantive restrictions on the ability of States and localities to issue debt securities the interest on which is free of Federal income tax. These Federal

[83] 1934 Amendments to the Bankruptcy Act of July 1, 1898, Chapter IX, Sections 78-80.

[84] 304 U.S. 27.

[85] 304 U.S. 27, 32-38.

> restrictions are demonstrably more intrusive upon the States' ability to raise revenue in the amounts and for the purposes that they see fit than TEFRA's registration requirement. Yet, until South Carolina's original complaint in this action in February 1983, the States had not challenged Federal regulation in this area. Seemingly,the States accepted these Federal regulations as the price of their ability to minimize their own interest costs by issuing Federal tax-exempt bonds.[86]

The Special Master's assumption that the States "accepted these federal regulations" is wholly without foundation.

It is true that the Congress began regulating municipal industrial development bonds in 1968 (although unsuccessful suggestions of such regulation were made earlier[87]). However, it is also true that the United States Treasury, certain Members of the Congress and even municipal issuers themselves (who joined clarifying amendments offered by Senator Howard Baker and Representative Wilbur Mills) questioned whether such bonds were "obligations of States or local governments".[88] Senator Howard Baker's proposed amendments (which he noted were supported by the National Governors Conference, the National Association of Attorneys General, the National Association of State Auditors, Comptrollers and Treasurers, the Council of State Governments, the National League of Cities, the United States Conference of Mayors, the Municipal Finance Officers Association (the forerunner of the GFOA) and the National Institute of Municipal Law Officers) were directed toward the presence in the financings of a private, taxable beneficial obligor, because, as Senator Baker observed:

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[86] Special Master's Report, p. 135.

[87] See e.g. *Repeal of Tax-Exempt Status of Certain Muncipal Bonds*, 107 Cong. Rec. 9139 (1961) and 107 Cong. Rec. 11901 (1961).

[88] See Conference Report on Revenue And Expenditure Control Act of 1968, P.L. 90-364, U.S. Code Congressional and Administrative News, 90th Cong., 2d Session (1968), p. 2379 *et. seq.*

> So long as the Congress does not propose to challenge the long-standing Constitutional rule of the states' and local governments' immunity from taxation of their obligations, the *only* basis for taxing any bonds issued by State or local governments is that they are the issuer's obligations in name only. . . .[89]

Likewise, in 1969 when the Congress extended such regulation to alleged arbitrage practices, the Senate in its report on the so-called Tax Reform Act of 1969 noted ". . . questions have been raised in such cases as to whether such bonds in reality are obligations of a State or local government where the proceeds from the securities acquired secure the payments under the initial bonds".[90]

Although no such demonstration is evident on the record the Special Master somehow found such regulation to be demonstrably more intrusive upon the State's ability to raise revenues in the amounts and for the purposes as determined by the States than the TEFRA requirements.[91] In fact, until the Deficit Reduction Act of 1984 and the Tax Reform Act of 1986, arbitrage prohibitions were not viewed as particularly intrusive since the evil which the Congress sought to correct in 1969 was, for all practical purposes, a myth and, as such, the restrictions imposed were not unduly burdensome.

The State Treasurer of South Carolina Grady L. Patterson, Jr. testified before the Senate Finance Committee at that time that with certain contemplated amendments the arbitrage provisions were acceptable.[92] Representatives of GFOA testified that properly defined "no such

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[89] 114 Cong. Rec. 30980 October 11, 1968. Emphasis in original. For the full text of Senator Baker's statement see Appendix F hereinafter.

[90] U.S. Code Congressional and Administrative News, 91st Cong., 1st Session (1969), p. 2254.

[91] Special Master's Report, p. 135.

[92] Committee on Finance, United States Senate, Tax Reform Act of 1969, H.R. 13270 p. 277, 279.

[arbitrage] bonds can be lawfully issued."[93] Investments of public funds are generally made awaiting the uses for which such funds were raised, and, in the large majority of cases the permissible periods for unlimited investment opportunity and the applicable construction or acquisition periods were in harmony.

The lack of litigation referred to by the Special Master in this area until the *South Carolina* case is also partially explained by the lack of a procedure for judicial review absent a taxpayer action. In 1978 the Congress sought to remedy this apparent deficiency, noting:

> As a practical matter, there is no effective appeal from a [Internal Revenue] Service private letter ruling (or failure to issue a private letter ruling) that a proposed issue of municipal bonds is taxable. In those cases, although there may be a real controversy between a State or local government and the Service, *present law does not allow the State or local government to go to court.* The controversy can be resolved only if the bonds are issued, a bondholder excludes interest on the bonds from income, the exclusion is disallowed, and the Service asserts a deficiency in its statutory notice of deficiency. This uncertainty coupled with the threat of the ultimate loss of the exclusion, invariably makes it impossible to market the bonds. In addition, it is impossible for a State or local government to question the Service rulings and regulations directly.[94] (emphasis added)

In response, a provision was added to the Internal Revenue Code permitting the Tax Court, the Court of Claims and the Federal District Courts to issue declaratory judgments as to the tax status of proposed municipal debt issuances.[95]

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[93] *Id.* at p. 79, 82. Summary of Joint Statement for GFOA, National Association of State Auditors, Comptrollers and Treasurers by Louis Goldstein, State Comptroller of Maryland and John D. Herbert, State Treasurer of Ohio, and Daniel B. Goldberg, counsel, Municipal Finance Officers Association (presently GFOA).

[94] 1978 U.S. Code Cong. & Admin. News, 6913.

[95] Internal Revenue Code § 7478.

Even if the acquiescence referred to by the Special Master did in fact exist or can be implied, any such acquiescence cannot change the constitutional immunity of interest on State and local obligations from federal income taxation. This Court has recently decided that a Congressional-veto structure utilized 295 times in 1,986 statutes from 1932-1975 and numerous times thereafter was unconstitutional [96] noting:

> the fact that a given law or procedure is efficient, convenient, and useful in facilitating functions of government, standing alone, will not save it if it is contrary to the Constitution.[97]

Additionally, if "acquiescence" may act as a bar to the assertion of a particular Constitutional right or protection, litigation (which might otherwise be avoided) in the Federal courts is the likely result. This increase in litigation is particularly likely insofar as the recently enacted Tax Reform Act of 1986 violates each of the standards that the Special Master found lacking in *South Carolina* v. *Regan*,[98] i.e., such Act changes how much the States may borrow,[99] the purposes for which they borrow,[100] how they decide to borrow [101] and other obviously important aspects of the borrowing process.[102]

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[96] *Immigration and Naturalization Service* v. *Chadha*, 462 U.S. 919, pp. 944-945.

[97] *Id.* at 944. This provision was cited to by the majority in *Charles A. Bowsher, Comptroller General of the United States* v. *Mike Synar, Member of Congress*, 478 U.S. ——, 92 L. Ed. 583, 603 (1986). Justice White in his dissent in *Bowsher* v. *Synar* notes that both the Congress and the Executive expressed their assent to the statute in contention. *Id.* at 617.

[98] Special Master's Report, p. 118.

[99] P.L. no. 99-514. Title XIII, Sections 1301 *et. seq.*, Section 146 of the Internal Revenue Code of 1986 provides for a volume cap on certain debt obligations.

[100] See Section 141 to 145 of the Internal Revenue Code of 1986.

[101] See Section 146 for State allocation of volume cap and public approval process.

[102] See Section 146(f) for rebate requirements of earnings to the Federal government which may raise questions as to a discrimi-

CONCLUSION

The Supreme Court would be remiss if it reviews the applicable provisions of the Internal Revenue Code (initially Section 103(j) of the Internal Revenue Code of 1954) narrowly without returning to subsection (a) of such Section and tracing the Congress' attempt to steadily erode State sovereignty. It is proper for the Court to ask whether the Sixteenth Amendment would have been ratified by the States if Senator Borah and his colleagues in the Senate had asserted that such Amendment implied that the Federal government could regulate, limit, direct, abolish or tax the borrowing power of the States or their instrumentalities. In *Bowsher* v. *Synar*, the Court noted how the interpretations of the first Congress provided "weighty evidence" of the Constitution's meaning since many Members took part in the Constitutional Convention.[103] In the instant situation the very Members who proposed and defended the Sixteenth Amendment consistently explained it *prior to ratification and for many years thereafter*.

The Court should particularly be aware that alternative compliance and enforcement methods are readily available to the Congress if the Court should find the registration requirement or penalty for failure to register to be unconstitutional. For a discussion of such alternatives please see the briefs filed in this case by the National Institute of Municipal Law Officers[104] and the National Governors' Association.[105]

It should be noted that to the extent registration of municipal securities is a desirable good, such good is achievable in ways other than imposing loss of tax exemption. The GFOA, along with others has suggested various ways of achieving compliance that is consistent

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natory and confiscatory tax applicable only to State and local governments.

[103] *Bowsher* v. *Synar*, 478 U.S. ——, 92 L. Ed. 2d 583, 595 (1986).

[104] *Amicus Curiae* Brief, September 1983.

[105] Brief of Plaintiff in Intervention, May 1987.

with the Federal objectives of hampering tax avoidance or the movement of illegal moneys.

A method which would achieve bond registration without denying tax exemption would be to impose a monetary penalty on persons purchasing tax-exempt bearer securities. This penalty, which would be in addition to the existing penalties, could virtually insure full compliance with bond registration. Another method to be considered would be the imposition of restrictions on the movement of bearer debt in interstate commerce which would operate through clearing banks and the Federal Reserve System.

To accept the Special Master's recommendation on the constitutionality of the penalty provision is to undercut further the vitality of the constitutional immunity from Federal taxation of income from State and municipal obligations and to lend support to the contention of some that the interest exemption is awarded at Congress' discretion rather than being constitutionally based.

The historical development of tax immunity is rooted in the very foundation of the federal system and, as such, cannot and should not be dismissed lightly. The power to tax can indeed be the power to destroy. If our system of federalism is to mean anything, neither the legislature nor the courts should tamper with the vital immunity of the States and their instrumentalities from the potentially coercive and destructive taxing power of the Federal government.[108]

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[108] For policy reasons as to why the Congress should not intrude in State and local activities see the remarks of Representative Rostenkowski in Appendix G hereto and as to Congress' stated intention to avoid intruding, see remarks of Senator Long in Appendix H hereto.

Respectfully submitted,

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APPENDIX A

MESSAGE OF GOVERNOR HUGHES

STATE OF NEW YORK
EXECUTIVE CHAMBER,
ALBANY

January 5, 1910

To the Legislature:

I have received from the Secretary of State of the United States a certified copy of a resolution of Congress entitled "Joint Resolution Proposing an Amendment to the Constitution of the United States," and in accordance with his request I submit it to your honorable body for such action as may be had thereon.

The amendment proposed by this joint resolution, adopted by two-thirds of both houses of Congress, is as follows:

> "Article XVI. The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."

The power to lay a tax upon incomes, without apportionment, was long supposed to be possessed by the Federal government and has been repeatedly exercised. Such taxes were laid and paid for the purpose of meeting the exigencies caused by the Civil War.

In 1895, in the case of Pollock v. Farmers' Loan & Trust Company (158 U.S. 601), the United States Supreme Court decided that taxes on the rents or income of real estate, and taxes on personal property or on the income of personal property, are direct taxes and hence under the Constitution cannot be imposed without apportionment among the several States according to their respective populations.

It was not the function of the court, and it did not attempt, to decide whether or not a Federal income tax

was desirable. It simply interpreted the Constitution according to the judgment of the majority of its members and left the question of the advisability of conferring such a power upon the Federal government to be determined in the constitutional method.

The limitations so placed upon the Federal taxing power are thus described by Mr. Justice Harlan in his dissenting opinion:

> "Any attempt upon the part of Congress to apportion among the States, upon the basis simply of their population, taxation of personal property or of incomes, would tend to arouse such indignation among the freemen of America that it would never be repeated. When, therefore, this court adjudges, as it does now adjudge, that Congress cannot impose a duty or tax upon personal property, or upon income arising either from rents of real estate or from personal property, including invested personal property, bonds, stock and investments of all kinds, except by apportioning the sum to be so raised among the States according to population, it practically decides that, without an amendment of the Constitution—two-thirds of both Houses of Congress and three-fourths of the States concurring—such property and incomes can never be made to contribute to the support of the national government. (Id., pp. 671, 2)
> * * *
>
> "Incomes arising from trades, employment, callings, and professions can be taxed, under the rule of uniformity or equality, by both the national government and the respective State governments, while incomes from property, bonds, stocks, and investments cannot, under the present decision, be taxed by the national government except under the impracticable rule of apportionment among the States according to population. No sound reason for such a discrimination has been or can be suggested." (Id., p. 680.)

I am in favor of conferring upon the Federal government the power to lay and collect an income tax without apportionment among the States according to population. I believe that this power should be held by the Federal government so as properly to equip it with the means of meeting national exigencies.

But the power to tax income should not be granted in such terms as to subject to Federal taxation the incomes derived from bonds issued by the State itself, or those issued by municipal governments organized under the State's authority. To place the borrowing capacity of the State and of its governmental agencies at the mercy of the Federal taxing power would be an impairment of the essential rights of the State which, as its officers, we are bound to defend.

You are called upon to deal with a specific proposal to amend the Constitution, and your action must necessarily be determined not by a general consideration of the propriety of a just Federal income tax, but whether or not the particular proposal is of such a character as to warrant your assent.

This proposal is that the Federal Government shall have the power to lay and collect taxes on incomes "from whatever source derived."

It is to be borne in mind that this is not a mere statute to be construed in the light of constitutional restrictions, express or implied, but a proposed amendment to the Constitution itself which, if ratified, will be in effect a grant to the Federal government of the power which it defines.

The comprehensive words, "from whatever source derived," if taken in their natural sense, would include not incomes from ordinary real or personal property, but also incomes derived from State and municipal securities.

It may be urged that the amendment would be limited by construction. But there can be no satisfactory assurance of this. The words in terms are all-inclusive. An

amendment to the Constitution of the United States is the most important of political acts, and there would be no amendment expressed in such terms as to afford the opportunity for Federal action in violation of the fundamental conditions of State authority.

I am not now referring to the advantage which the State might derive from the exclusive power to tax incomes from property, or to the argument that for this reason the power to tax such incomes should be withheld from the Federal government. To that argument I do not assent.

I am referring to a proposal to authorize a tax which might be laid in fact upon the instrumentalities of State government. In order that a market may be provided for State bonds, and for municipal bonds, and that thus means may be afforded for State and local administration, such securities from time to time are excepted from taxation. In this way lower rates of interest are paid then otherwise would be possible. To permit such securities to be the subject of Federal taxation is to place such limitations upon the borrowing power of the State as to make the performance of the functions of local government a matter of Federal grace.

This has been repeatedly recognized. In the case of The Collector v. Day (11 Wall. on p. 127), decided in 1870, the United States Supreme Court said:

> "It is admitted that there is no express provision in the Constitution that prohibits the general government from taxing the means and instrumentalities of the States, nor is there any prohibiting the States from taxing the means and instrumentalities of that government. In both cases the exemption rests upon necessary implications, and is upheld by the great law of self-preservation; as any government, whose means employed in conducting its operations, if subject to the control of another and distinct government, can exist only at the mercy of that govern-

ment. Of what avail are these means if another power may tax them at discretion?"

In the case of Pollock v. Farmers' Loan & Trust Co. (157 U.S. on pp. 584-5), Chief Justice Fuller said, referring to the tax upon incomes from muncipal bonds, one of the matters there involved:

> "A municipal corporation is the representative of the State and one of the instrumentalities of the State government. It was long ago determined that the property and revenues of municipal corporations are not subjects of Federal taxation. * * * But we think the same want of power to tax the property or revenues of the States or their instrumentalities exists in relation to a tax on the income from their securities."

In the same case Mr. Justice Field said (Id. on p. 601):

> "These bonds and securities are as important to the performance of the duties of the State as like bonds and securities of the United States are important to the performance of their duties, and are as exempt from the taxation of the United States as the former are exempt from the taxation of the States."

And the learned Justice added, quoting from United States *v.* Railroad Co. (17 Wall. on pp. 322, 327) as follows:

> "The right of the States to administer their own affairs through their legislative, executive, and judicial departments, in their own manner through their own agencies, is conceded by the uniform decisions of this court, and by the practice of the Federal government from its organization. This carries with it an exemption of those agencies and instruments from the taxing power of the Federal government. If they may be taxed lightly, they may be taxed

heavily; if justly, oppressively. Their operation may be impeded and may be destroyed, if any interference is permitted. Hence, the beginning of such taxation is not allowed on the one side, is not claimed on the other."

While the justices of the court in the Pollock cases differed in opinion upon the question whether a tax upon income from property was a direct tax and as such could not be laid without apportionment, they were unanimous in their conclusion that no Federal tax could be laid upon the income from municipal bonds. Mr. Justice White, who dissented in the Pollock case with regard to other questions, as to this said (157 U.S. on p. 652):

> "The authorities cited in the opinion are decisive of this question. They are relevant to one case and not to the other, because, in the one case, there is full power in the Federal government to tax, the only controversy being whether the tax imposed is direct or indirect; while in the other there is no power whatever in the Federal government, and, therefore, the levy, whether direct or indirect, is beyond this taxing power."

It is certainly significant that the words, "from whatever source derived," have been introduced into the proposed amendment as if it were the intention to make it impossible for the claim to be urged that the income from any property, even though it consist of the bonds of the State or of a municipality organized by it, will be removed from the reach of the taxing power of the Federal government.

The immunity from Federal taxation that the State and its instrumentalities of government now enjoy is derived not from any express provision of the Federal Constitution, but from what has been deemed to be necessary implication. Who can say that any such implication with respect to the proposed tax will survive the adoption of this explicit and comprehensive amendment?

We cannot suppose that Congress will not seek to tax incomes derived from securities issued by the State and its municipalities. It has repeatedly endeavored to lay such taxes and its efforts have been defeated only by implied constitutional restriction which this amendment threatens to destroy. While we may desire that the Federal government may be equipped with all necessary national powers in order that it may perform its national function, we must be equally solicitous to secure the essential bases of State government.

I therefore deem it my duty, as Governor of the State, to recommend that this proposed amendment should not be ratified.

CHARLES E. HUGHES

New York State Senate Journal, 133rd. Session, Vol. 2, Executive Journal, pp. 54-60.

APPENDIX B

LETTER TO SENATOR ROOT

Washington, D.C.
February 17, 1910

MY DEAR SENATOR:

Since our conversation last month I have given much consideration to the scope and effect of the proposed income tax amendment to the Constitution of the United States.

Much as I respect the opinion of the governor of the State, I can not agree with the view expressed in his special message of January 5, and as I advocated in the Senate the resolution to submit the proposed amendment, it seems appropriate that I should state my view of its effect.

The proposed amendment is in these words:

"ART. 16. The Congress shall have the power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States and without regard to any census or enumeration."

The objection made to the amendment is that this will confer upon the National Government the power to tax incomes derived from bonds issued by the States or under the Authority of the States, and will place the borrowing capacity of the State and its governmental agencies at the mercy of the Federal taxing power.

I do not find in the amendment any such meaning or effect, I do not consider that the amendment in any degree whatever will enlarge the taxing power of the National Government or will have any effect except to relieve the exercise of that taxing power from the requirement that the tax shall be apportioned among the several States. The effect of the amendment will be in my view,

the same as if said, "The United States may lay a tax on incomes without apportioning the tax, and this shall be applicable whatever the source of the income subjected to the tax," leaving the question, "What incomes are subject to national taxation?" to be determined by the same principles and rules which are now applicable to the determination of that question.

If we were to construe the proposed amendment only by a critical examination of its words, the view upon which the objection is based would be reached by practically cutting the provision in two and reading it as if it read, "the Congress shall have the power to lay and collect taxes on incomes from whatever source derived," without the concluding words. But we are not at liberty to do this. The amendment consists of a single sentence and the whole of it must be read together. It expresses but a single idea, and that is that the tax to which it relates must be laid and collected without apportionment among the several States and without regard to any census or enumeration, while the words "from whatever source derived" are obviously introduced to make the exemption from the rule of apportionment comprehensive and applicable to all taxes on incomes.

We are not left, however, to a mere critical examination of words. This provision, as Mr. Justice Bradley said of the Constitution in the Legal tender cases, is "to be interpreted in the light of history and of the circumstances of the period in which it was framed." Justice Story said of another clause of the Constitution, in Brisco v. The Bank of Kentucky (2 Peters, 332).

> "And I mean to insist that the history of the colonies before and during the Revolution and down to the very time of the adoption of the Constitution constitutes the highest and most authentic evidence to which we can resort to interpret this clause of the instrument, and to disregard it would be to blind ourselves to the practical mischiefs which it was

meant to suppress and to forget all the great purposes to which it was to be applied."

This view must necessarily be applied to the proposed amendment if it be adopted. It will be construed in the light of the judicial and political history which led to the proposal and which appears upon the public records of our Government.

What is that history? The Constitution of 1787 conferred upon the National Government the power of taxation without any limit whatever, except that taxes on exports were prohibited.

The method of exercising the power, however, was subjected to two limitations. One, that imposts, duties, and excises should be uniform, and the other that direct taxes should be apportioned among the States. The apportionment provisions were as follows:

"ARTICLE I.

"SEC. 2. Representatives and direct taxes shall be apportioned among the several States which may be included within this Union according to their respective numbers," etc. (Amended, but not in this respect, by the fourteenth amendment.)

"SEC. 9. No capitation or other direct tax shall be laid unless in proportion to the census or enumeration before directed to be taken."

For more than a hundred years after the adoption of the Constitution various tax laws of Congress were from time to time brought before the courts upon objections that they imposed direct taxes in violation of the rule of apportionment. The decisions of the courts uniformly sustained these laws, from the Hylton case, in 1796, which sustained an unapportioned tax on carriages (3 Dallas, 171), to the Springer case, in 1880, which sustained an unapportioned tax on incomes. (102 U.S., 586.)

In the meantime numerous laws were passed and enforced imposing taxes on incomes without apportionment,

and a great part of the means for carrying on the Civil War was derived from such taxes.

In the year 1895, however, an income tax law included in the Wilson tariff act of 1894 was brought before the Supreme Court in the case of Pollock against the Farmers' Loan & Trust Co., and in that case the court decided against the law. The case was heard twice. On the first hearing a majority of the court held that a tax on income derived from real estate must be apportioned as a direct tax, because a tax on real estate itself would be direct, and the judges divided equally as to whether a tax on income derived from personal property must be apportioned. (157 U.S., 429.)

Upon the second hearing of the case the court, by a majority of five to four, held that a tax upon income derived from personal property must be considered a direct tax and must be apportioned (158 U.S., 601). All the judges agreed, however, that taxes on incomes derived from business or occupations need not be apportioned. The effect of these decisions was thus described in one of the minority opinions:

> "But the serious aspect of the present decision is that by a new interpretation of the Constitution it so ties the hands of the legislative branch of the Government that without an amendment of that instrument, or unless this court at some future time should return to the old theory of the Constitution, Congress can not subject to taxation—however great the needs or pressing the necessities of the Government—either the invested personal property of the country, bonds, stocks, and investments of all kinds, or the income arising from the renting of real estate or from the yield of personal property, except by the grossly unequal and unjust rule of apportionment among the States. Thus, undue and disproportioned burdens are placed upon the many, while the few, safely entrenched behind the rule of apportionment

among the States on the basis of numbers, are permitted to evade their share of responsibility for the support of the Government ordained for the protection of the rights of all."

It was so evidently impossible to collect an income tax apportionment among the States according to population that the general judgment of the country confirmed the opinion that the decision in the Pollock case had practically taken away from the Congress a power of vital importance to the General Government—a power the exercise of which had, at least in one time of peril, proved essential to the Nation's life.

The attention of the country was sharply called to the need of more Government revenue for the first time after the Pollock case by the decrease of customs and internal revenue receipts and the rapidly mounting deficit which followed the financial panic of 1907; and in the extraordinary session of Congress which began March 15, 1909, when the revised tariff bill came into the Senate, an amendment to the bill was introduced reproducing in substance the old income tax provisions of 1894 which the Supreme Court had held to be invalid both as to income derived from real estate and as to income derived from personal property. The avowed and necessary effect of including such provisions in the new tariff law would be to present again to the Supreme Court the same questions which had been decided in the Pollock case and to challenge a reversal of their decision. Thereupon the resolution for the submission of this amendment was introduced in the Senate and was passed by Congress.

The proposal followed the suggestions of the Supreme Court in the Pollock case.

The evil to be remedied was avowedly and manifestly the incapacity of the National Government resulting from the decision that income practically could not be taxed when derived either from real estate or from personal

property, although it could be taxed when derived from business or occupation.

The terms of the amendment are apt to cure that evil and to take away from the different classes of income considered by the court a practical immunity from taxation based upon the source from which they were derived.

There was no question in Congress or in the courts or in the country about the taxation of State securities. No one claimed that the inability of the General Government to tax them was an evil. The inability to tax them did not arise from the terms of the Constitution, but from the fact that, being the necessary instruments of carrying on other and sovereign governments, they were not the proper subject of national taxation, and that, therefore, no provisions of the Constitution, however wide the scope of their language, could be held to apply to such securities or to the income from them. Judge Cooley, in his work on Constitutional Law, says:

> "The power to tax, whether by the United States or by the States, is to be construed in the light of, and limited by, the fact that the States and the Union are inseparable, and that the Construction contemplates the perpetual maintenance of each with all its constitutional powers, unembarrassed and unimpaired by any action of the other. The taxing power of the Federal Government does not therefore extend to the means or agencies through or by the employment of which the States perform their essential functions, etc."

This rule of construction has been maintained for generations. It is undisputed; it was referred to with approval by the justices who wrote and delivered the opinions in the Pollock case both for and against the judgment. It has been declared again and again by the Supreme Court to be not open to question. It is a rule of construction just as controlling in defining the scope of the proposed amendment as it is in defining the scope

of the existing provisions. Under it, from the earliest times of our Government, the apparently unlimited taxing power conferred by the terms of the Constitution has been held not to apply to the instrumentalities of the State. Under it acts of Congress which by their express terms appeared to include instrumentalities of State government have uniformly been held not to include them; this uniform, long-established, and indisputable rule applied to the construction of our Constitution—a rule which has been declared to be essential to a continuance of our dual system of government—forbids that the words of that instrument conferring the power of taxation shall be deemed to apply to anything but the proper subjects of national taxation. Under it we are forbidden to apply the words "from whatever source derived" in the proposed amendment to any of the instrumentalities of State government.

This amendment will be no new grant of power. The Congress already has power to impose taxes on incomes from whatever source derived subject to the rule of construction which excludes State securities from the operation of the power, but the taxes so imposed must be apportioned among the States. Under the proposed amendment there will be the same and no greater power to tax incomes, from whatever source derived, subject to the same rule of construction, but relieved from the requirement that the tax shall be apportioned.

It appears, therefore, that no danger to the powers or instrumentalities of the States is to be apprehended from the adoption of the amendment.

It would be cause for regret if the amendment were rejected by the Legislature of New York.

It is said that a very large part of any income tax under the amendment would be paid by citizens of New York. That is undoubtedly true, but there is all the more reason why our legislature should take special care to exclude every narrow and selfish motive from influence

upon its action and should consider the proposal in a spirit of broad patriotism and should act upon it for the best interests of the whole country.

The main reason why the citizens of New York will pay so large a part of the tax is that New York City is the chief financial and commercial center of a great country with vast resources and industrial activity. For many years Americans engaged in developing the wealth of all parts of the country have been going to New York to secure capital and market their securities and to buy their supplies. Thousands of men who have amassed fortunes in all sorts of enterprises in other States have gone to New York to live, because they like the life of the city or because their distant enterprises require representation at the financial center. The incomes of New York are in a great measure derived from the country at large. A continual stream of wealth sets toward the great city from the mines and manufactories and railroads outside of New York. The United States is no longer a mere group of separate communities embraced in a political union; it has became a product of organic growth, a vast industrial organization covering and including the whole country; and the relation of New York City to the whole organization of which it is a part is the great source of her wealth and the chief reason why her citizens will pay so great a part of an income tax. We have the wealth because behind the city stands the country. We ought to be willing to share the burdens of the National Government in the same proportion in which we share benefits.

The circumstances that originally justified the establishment of the rule of apportionment in the Constitution have long since passed away. It is universally conceded that its application to existing conditions would be so unjust and inequitable as to be impossible. The power of taxation which the rule makes it impossible for the Nation to exercise may be again, as it has once been, vital to the preservation of national existence. It would be

most unfortunate if the several States of the Union were to insist upon the continuance of this unjust and useless limitation upon the necessary powers originally and wisely granted to the National Government.

With kind regards, I am always

Faithfully yours,

ELIHU ROOT

To: Hon. Frederick M. Davenport,
Senate Chamber, Albany, N.Y.

On February 15, 1910, a resolution had been introduced in the New York State Senate requesting that Senator Root be invited to address the State Legislature on the proposed amendment, *New York State Senate Journal*, 133rd Session, 1910, vol. 1, p. 147. Senator Davenport presented the above letter to the Senate on February 28, 1910 and copies were ordered printed and referred to the Committee on the Judiciary. Id. at 236.

APPENDIX C

REPORT OF SENATOR AUSTIN

During the September 19, 1940 discussion with Senator Brown, Senator Austin requested permission to insert the following matter in the Record, 86 Cong. Rec. 12294. It appears at pages 12297-12298.

Governor Plaisted said:

"In approving the proposed amendment we are not conferring any new right on the Nation, nor are we taking any right now reserved to the State."

Governor Hadley said:

"I do not believe that objection therein urged is likely to arise as a result of this power by the National Congress if conferred, and, if it should arise, it is my opinion that under the decisions of the Supreme Court of the United States, it is not well founded in law. And this is the position that has been taken by some of the most prominent representatives in the National Congress in the discussions of this question."

Governor Fort said:

"Nor am I inclined to accept the statement that the Supreme Court * * * might construe the words 'from whatever source derived' * * * as justifying the taxing of the securities of any other power."

* * * * *

"I think the principle thus quoted, which is founded upon public policy, would obtain, in construing a constitutional provision, equally as firmly as in the construction of an act of Congress."

Governor Noel said:

"I do not concur in either the view or the recommendation of Governor Hughes in opposition to the income-tax amendment. I do not believe the courts would hold that

authority to tax incomes would authorize any action that would impair any instrumentality of the State or municipal governments."

Governor Harmon said:

"I have recommended ratification of the income-tax amendment. Comity between kindred sovereignties should require the amendment to be taken as applying to incomes from private sources only * * *."

Still other Governors showed doubts as to Governor Hughes' view. Thus, for example, Governor Baldwin, of Connecticut, said:

"It is unfortunate that the wording of the proposed amendment is such as to raise upon its face a doubt as to its meaning in respect to a material point. In the view of some lawyers, it would authorize Congress to tax holders of State securities * * *. In the view of other lawyers, the amendment would not affect the existing rule * * *."

Governor Marshall, of Indiana, said:

"* * * It may be conferring upon the General Government a larger power in the nature of taxation than the States have ever intended to confer, * * *."

Governor Norris, of Montana, said:

"Some objections have been made to the adoption of the amendment on the ground that the words 'from whatever source derived' permit the levy of a tax on incomes received from State * * * indebtedness * * *."

Governor Burke, of North Dakota, said:

"Some of the ablest lawyers in the land object to the broad terms in which the language giving the power to tax is couched. * * * While on the other hand just as able lawyers insist that the Constitution contemplates the independent exercise by the Nation and the States of their constitutional powers and the obligations of the State cannot be impaired by this grant of power."

To sum up, the situation with respect to the ratifying States was this: Mr. Hughes, as Governor of the State of New York, voiced fears that the proposed amendment might be interpreted as possibly opening the door to the taxation of the income from State and municipal bonds. This view, however, was officially controverted by Senators Borah, Root, and Brown. Of these three, Senator Borah was the leading spirit behind the amendment. Senator Brown officially introduced it and Senator Root was credited, by at least one authority, with being the actual author of the amendment; and, moreover, he was one of Governor Hughes' two representatives in the Senate. Following their respective interpretations, no one in the Senate or House rose to challenge their views. John Phillip Wenchel, chief counsel, Bureau of Internal Revenue, has inadvertently created the impression that the opposition to the Borah-Root-Brown views was voiced on the floor of the Senate. Thus, in the paper entitled "Legal Discussion," which he filed before the Senate Committee on Intergovernmental Taxation, he quoted language from Senator Edmunds, of Vermont, which would indicate that the latter gentleman disagreed with or challenged the Borah-Root-Brown views on the floor of the Senate. What happened is this: Former Senator Edmunds, of Vermont, addressed a letter to a then Senator. In this letter the former Vermont Senator strongly condemned the possible taxation of State and munincipal securities, as well as the whole theory of the income tax. The latter was printed in the RECORD, without discussion. Thus the States can reassert the proposition that the Borah-Root-Brown views of the amendment were not challenged in the Senate or House.

The Department of Justice erroneously and fallaciously concludes that when the States ratified the amendment without referring to either of two diverse schools of thought, the States must have accepted the view most favorable to the contentions urged by the Department of Justice. This is, of course, absurd on its face. And moreover if silence may be regarded as acquiescence (in some

circumstances) it is absurd to argue that in this case it amounted to an acceptance of Governor Hughes' fears. If silence gives rise to acquiescence, surely it is acquiescence in the latest views expressed in a controversy. After Governor Hughes voiced his fears, others said they were groundless and unjustified under the language and intent of the amendment. The States submit, therefore, that it cannot be argued with force that because of a State's omission to challenge Governor Hughes' fears, it acquiesced in the surrender of its sovereignty.

It is, of course, absurd to suppose that the States intended—in ratifying the sixteenth amendment—to give up their immunity from tax by the Federal Government without the Federal Government in turn giving up its immunity. It is ridiculous to suppose that the States would have intended to ratify the amendment under such circumstances.

The record fails to support any conclusion that the amendment was ratified by the States in acceptance of the view that it was intended to vest Congress with the power to tax State and municipal bonds.

APPENDIX D

REMARKS OF REPRESENTATIVE CORDELL HULL

The following exchange accompanied introduction of the Tariff-Income Tax Bill, H.R. 3321, 93rd Cong., 1st Sess. (1913):

> Mr. HULL: . . . Paragraph C exempts from the law salaries of State and local officers and interest upon State and local bonds. The Supreme Court has often held that under our form of government the States have no power to tax the instrumentalities of the Federal Government, and conversely that the Federal Government has no power under the Constitution to tax the instrumentalities of the States; not desiring to raise any constitutional question, or to arouse the antagonism of any of the States, this provision was inserted.
>
> Mr. BARTLETT: May I interrupt the gentlemen?
>
> Mr. HULL: Certainly.
>
> Mr. BARTLETT: It is a fact that in my State and in a number of other States, when this amendment was up before the legislature for adoption, many people opposed the adoption of the amendment because there was nothing specifically said in the amendment that excepted State, municipal, and other subdivisions of State bonds from taxation under the proposed amendment: but the friends of the amendment felt justified in assuring them that except in great stress, except in time of war, Congress would never think it wise to tax the bonds of the State or the subdivisions thereof.
>
> Mr. HULL: Mr. Chairman, I think the suggestion of the gentleman is entirely pertinent.
>
> MR. BARTLETT: In other words, the people were assured by the friends of this measure that it would be only in rare cases that Congress would ever be

called upon to enact any law which would tax the instrumentalities of a State or a subdivision thereof.

Mr. HULL: I do not undertake to express an opinion either way upon the power of Congress to impose such tax by virtue of the recent constitutional amendment. It does not necessarily arise in view of the provision in the bill.

50 Cong. Rec. 508 (1913).

APPENDIX E

REMARKS OF SENATOR THOMAS

After passage by the House of Representatives, Senator Thomas greeted a pending revenue bill with the following remarks:

> While constitutional questions have during the war became recondite, their intrusion upon novel and comprehensive schemes of legislation can not be prevented. Here they lie upon the very surface of the bill. The House report reveals and briefly disposes of them upon considerations of justice and equity. That is an easy method. If sound, we shall have no difficulty in removing restraints upon our legislative powers. We can relegate the Constitution to the limbo of things that were, and measure our authority by our discretion, should we care to retain that faculty. Personally, I am unable to reconcile my oath of office with this new standard of construction, although in the given instance it negatives the conclusion asserted.
>
> The pending bill is obnoxious to the Constitution in not less than three important particulars. I refer to the proposed taxation . . . of State, and municipal securities and salaries . . . .
>
> The bill also includes on [sic] gross incomes the "interest from the obligations of States and political subdivisions thereof issued after its passage," together with the compensation of State and municipal officers. These items have also been excluded either expressly or by judicial decision from previous income tax legislation. Of the unconstitutionality of this proposed imposition, I entertain no doubt whatever.

56 Cong. Rec. 10,628-29 (1918).

APPENDIX F

STATEMENT OF SENATOR BAKER

On June 28, 1968, President Johnson signed into law as Section 107 of the Revenue and Expenditure Control Act of 1968 a measure to eliminate the tax-exempt status of industrial development bonds. The amendment which I introduce is an attempt to correct the present distorted definition of "industrial development bonds," which is not limited to bonds for industrial development, but rather is so broad as to include bonds for many acknowledged and traditional state and local governmental functions.

Members of Congress who supported the taxation of "industrial development bonds" now realize that by means of the definition employed in the Act, they have gone much further than they intended. Chairman Wilbur Mills of the House Ways and Means Committee acknowledged this fact on the floor at the time of passage of the Act and invited the National Governors Conference and others to propose corrective legislation. Without such correction, the 90th Congress will have challenged the exemption of state and local governmental bonds issued for a host of acknowledged governmental functions wholly unrelated to the industrial development bond problem.

The amendment which I offer is basically a portion of a bill introduced by Congressman Mills in the House of Representatives and by Senator Curtis in the Senate after passage of the Revenue and Expenditure Control Act. A few technical refinements have been made to dispose of minor objections. This amendment has the support of the National Governors Conference; the National Association of Attorneys General; the National Association of State Auditors, Comptrollers and Treasurers; the Council of State Governments; the National League of Cities; the United States Conference of

Mayors; the Municipal Finance Officers Association; and the National Institute of Municipal Law Officers.

I recognize that this is a complex area and that hearings on this question would be desirable. In fact, I believe we are confronted with the present distorted definition because no hearings were held prior to the enactment of the Ribicoff Amendment. I believe that the definition which I offer is far superior to the present statutory language and that, at the very least, it will serve as a corrective measure until this question can be fully aired during the next legislative session.

The practical effect of the present definition is to include within that definition bonds for practically any state or local governmental purpose if the financed facility would have private occupants paying to use it. Thus, the enacted definition includes, among other, bonds for markets, nursing homes, piers, fairs, and recreational facilities.

It is true that the present act does not tax all of the bonds it labels "industrial development bonds." What the present act does is set up a list of approved purposes labeled "exceptions." Bonds for these purposes remain exempt and those for all other state and local governmental purposes are taxable when private occupants pay to use the financed facilities. Thus, the Congress purported to classify as good or bad all the legitimate functions of state and local government, rewarding good purposes with exemption and penalizing bad purposes with taxation. Among the bad purposes are such fundamental governmental functions as education and health care, which are totally unrelated to the development of new industrial plants.

The present list of enacted exceptions presents substantial difficulties. For example, as originally passed by the Senate, there was an exception for property "to provide entertainment (including sporting events) or recreational facilities for the general public." As enacted, this

was cut down to "sports facilities" with the result that an exemption is currently provided for bonds to finance a stadium built for rental to a professional baseball team shopping for a more lucrative franchise, but no exemption is provided for a public theater for lease to a company providing concerts and drama.

As another example, the exception in the present act for terminal facilities includes airports and piers for air and marine vehicles, but does not include terminals for land vehicles such as buses, trucks, or railroads.

Finally, facilities for education or health care are not among the listed exceptions in Section 103(c)(4).

This type of continuing regulation by selection of state and local governmental functions has no proper place in our federal system and accordingly should be abandoned.

The amendment which I introduce would provide a general redefinition of "industrial development bond" in accordance with the generally accepted meaning of the term. Section 1 requires that some private person who is not an "exempt person" must be the apparent "beneficial obligor" and that the bond be issued to finance "industrial property" or "independent wholesale or retail property." "Industrial property" would be limited to its natural meaning of factory-type structures and equipment. It would not include facilities in factories for the abatement of air or water pollution, waste disposal, or other health or safety functions. "Industrial wholesale or retail property" includes structures for shops as well as retail department stores and similar mercantile establishments. The definition of "exempt person" is retained from the present act and includes governmental units and educational, charitable, and other tax-exempt institutions.

The requirement of a private, taxable, "beneficial obligor" is critical. So long as the Congress does not propose to challenge the long-standing Constitutional rule of

the states' and local governments' immunity from taxation of their obligations, the *only* basis for taxing any bonds issued by state or local governments is that they are the issuers' obligations in name only, that the issuer is disassociated from the obligation and from the facility financed, and the investor considers the private user as the true obligor.

The attributes of such a disassociation, as set forth in the amendment are: (1) the putative private obligor will be using the property financed under lease or other contractual arrangement which requires him to pay all or most of the funds needed to meet debt service on the obligations, and (2) the putative private obligor and his contractual arrangement are identified in the bond agreement or in the offering prospectus, and his payments thereunder and/or the financed property are specifically pledged or mortgaged to secure the bonds.

I recognize that there has been some abuse in some local industrial development bond projects. This amendment would require the taxation of bonds for industrial development in cases of acknowledged abuse but would not include bonds issued for traditional state and local governmental functions. I strenuously object to any legislation which attempts to repeal outright the tax exemption on state and local bonds or to any legislation which penalizes or rewards the states by taxation or exemption, depending on whether the federal government approves or disapproves of the purpose for which the bond is issued. The method of classifying various bond issues as acceptable or unacceptable to the federal government is a dangerous development and an unwise precedent.

I do not believe that Congress should have, in a cavalier fashion and in the absence of hearings, revoked the tax-exempt status of industrial development bonds. At the very least, I believe this redefinition in accordance with the generally accepted meaning of the term should be adopted.

114 Cong. Rec. 30980 (October 11, 1968).

APPENDIX G

REMARKS OF REPRESENTATIVE DAN ROSTENKOWSKI

During the Congressional discussion on the Municipal Taxable Bond Alternative Act of 1976, Representative Dan Rostenkowski stated his reluctant opposition to such proposal:

> My opposition to this legislation is based not on the present structure of the bill but on what I conceive to be a potential development that would result from extensive use of the subsidized taxable bond option. Under present law, the use of tax-exempt bond financing by cities and states is strictly a local matter. Decisions to issue bonds as well as decisions on how and where to spend the resulting revenue are strictly local decisions made either by the voters directly or indirectly, through officials chosen to represent them.
>
> On the surface, H.R. 12774 does nothing to alter that situation, State and local governments will continue to issue bonds for projects they feel are necessary . . .
>
> My concern rests with the interest subsidy paid by the federal government. To the extent municipalities come to be reliant on the interest subsidy, they expose themselves to the risk of further federal control.
>
> Although this particular legislation offers the federal payment with no strings attached, it would be premature—and I believe somewhat naive—for local governments to believe that federal strings or conditions could not at some time in the future be attached—through either congressional legislation, bureaucratic regulation or judicial interpretation. It is not inconceivable to me to visualize the day

when the interest subsidy would be withheld if the purpose of the bond issue were either inconsistent with or in violation of some federal policy that was fashionable at that particular time . . .

In the end, cities that lose control of their finances, lose control of their destinies.

MUNICIPAL TAXABLE BOND ALTERNATIVE ACT OF 1976, Report from the Committee on Ways and Means to accompany H.R. 12774, 94th Cong., 2d session, Report No. 94-1016.

APPENDIX H

REMARKS OF SENATOR RUSSELL LONG

During the 1983 Senate discussions concerning the Social Security Commission recommendations and a proposal to include tax exempt income from municipal securities in determining whether or at what level social security payments were to be taxed, Senator Long criticized the proposal as an indirect attack on what he described as a constitutionally derived right of state sovereignty. Senator Long stated:

> We had this same issue before us on the TEFRA bill, and the Senate voted by a clear margin to strike out the proposal that would put the minimum tax on State and municipal bonds. It recognized the same principal which has been upheld by great Justices down through the years, including Justice Charles Evans Hughes, that we do not have the power to do that. And the Congress, Mr. President, has in the main denied the Internal Revenue Service the right to take the States to court to try to prove that they could tax these bonds under the Constitution. Congress has expressly put in the law up to this point that the income from these State and municipal bonds is not taxable, and that it is not our purpose to tax them. The Congress has also kept the faith that the sponsors of the constitutional amendment permitting the income tax made when they passed that amendment and assured the State legislatures that it did not tax these bonds, that it was not their intention to do that, and that they did not do that.
>
> Cong. Rec. S3730, 3735 (daily ed. Mar. 23, 1983).

The Social Security proposal was subsequently adopted after assurances by Senator Dole and others that the intent was not to "tax tax-exempt income", *id.* at S3736, but rather to avoid increased incentives for the buying

of tax exempt obligations, *id.* at S3737. It should be noted that Senator Moynihan inserted in the record a memorandum to the effect that such taxation would be constitutional, *Id.* at S3738.

Supreme Court, U.S.
FILED
1987

No. 94, Original

IN THE SUPREME COURT OF THE UNITED STATES
OCTOBER TERM, 1986

STATE OF SOUTH CAROLINA,
PLAINTIFF,

NATIONAL GOVERNORS' ASSOCIATION,
PLAINTIFF-IN-INTERVENTION,

v.

JAMES A. BAKER, III, SECRETARY OF THE
TREASURY OF THE UNITED STATES OF AMERICA,
DEFENDANT.

EXCEPTIONS OF THE STATE OF SOUTH CAROLINA TO THE REPORT OF THE SPECIAL MASTER AND BRIEF IN SUPPORT THEREOF

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QUESTIONS PRESENTED

1. Application of the penalty provision of Section 103 of TEFRA which requires federal taxation of the proceeds of the State of South Carolina's bond issues unless the bonds are issued in accordance with congressional regulations violates the doctrine of reciprocal tax immunity and the Sixteenth Amendment.

2. Application of the penalty provision of Section 103 of TEFRA which requires federal taxation of the proceeds of the State of South Carolina's bond issues unless the bonds are issued in accordance with congressional regulations violates the Tenth Amendment and notions of Federalism.

JURISDICTION

This action is an original jurisdiction matter. South Carolina v. Regan, 465 U.S. 367 (1984). The Honorable Samuel J. Roberts, Special Master, appointed pursuant to the order of this Court, 466 U.S. 948, issued his report on January 22, 1987.

This Court received the report on February 23, 1987, and issued its order granting the parties forty-five days to file exceptions with supporting briefs. On March 11, 1987, this Court granted South Carolina's request for additional time to file its exceptions to the Report of Special Master (hereinafter Report) until May 9, 1987.

STATEMENT

This case presents the question of whether Congress may impose as a penalty the loss of tax immunity for the proceeds of the State of South Carolina's general obligation bond instruments if the State fails to issue its bonds in registered form -- the method preferred by Congress. The Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), Pub. L. No. 97-248, 96 Stat. 595, Section 310(b)(1), codified at 26 U.S.C. Section 103(j) (1982), denies an exemption for federal income tax on interest paid on any "registration required" obligation unless the obligation is in registered form. Section 310(b)(1) provides:

> (j) Obligations must be in registered form to be tax-exempt
>
> Nothing in subsection (a) or in any other provision of law shall be construed to provide an exemption from Federal income tax for interest on any registration-required obligation

unless the obligation is in registered form.

Section 310(b)(1) defines registration-required obligations broadly to include most publicly offered municipal obligations with maturities of issue of one year or more. The Master concluded that "[s]ince the forfeiture of tax-exempt status would increase the interest that states and localities have to pay on their obligations by some 28% to 35%, Section 310(b)(1) in effect requires the registration of all municipal bonds." Report at 2 (footnote omitted).

In determining to exercise original jurisdiction, four of the Justices -- the former Chief Justice, Justices Brennan, Marshall and White -- found it to be unquestionable that "the manner in which a State may exercise its borrowing power is a question that is of vital importance to all 50 States." Regan, 465 U.S. at 382. Justice

Blackmun said the issue presented was "a substantial one" and "of concern to a number of States." Id. at 384.

An additional three Justices -- O'Connor, Powell and Rehnquist -- found the authority claimed by South Carolina to have "significant historical basis" and the injury alleged "could deprive it of a meaningful political choice." Id. at 401. Although Justice Stevens felt the State's claim lacked merit, he observed that "[a]s a practical matter, this requirement will force South Carolina to issue its bonds in registered form." Id. at 404.

On June 22, 1984, the National Governors' Association filed a motion for leave to intervene as Plaintiff. The Court referred the motion to the Special Master, who granted it on November 16, 1984.

A majority of the States filed amicus curiae briefs on behalf of the Plaintiff South Carolina as did the Government Finance

Officers Association, The National Institute of Municipal Law Officers, The Council of State Governments, National Association of Counties, National Conference of State Legislatures, National League of Cities, States Conference of Mayors, International City Management Association, and Public Securities Association.

Following a period of discovery, the Master heard testimony of various witnesses and oral arguments of counsel. The Master issued a report setting forth his factual findings and legal analysis. The Master acknowledged that his "report and recommendations are purely advisory. The Court itself will determine to grant or deny the ultimate relief sought. See R. Stern, E. Gressman, and S. Shapiro, Supreme Court Practice at 495 (6th Ed. 1986)." Report at 6. He concluded the Plaintiff South Carolina and the recommended Plaintiff-In-Intervention National Governors' Association

were not entitled to relief and recommended judgment to the Defendant.

EXCEPTIONS

1. The Plaintiff excepts to the Special Master's finding that municipal issuers have raised no serious challenge to the constitutionality of Congress' previous decisions to regulate industrial development and arbitrage bonds. The Master's finding is irrelevant, beyond the issues raised in the pleadings, and to the extent it is a finding to support the Plaintiff's acquiescence in the field of congressional regulation of the Plaintiff's taxing authority or to estopp the Plaintiff in this action, it is unsupported by the record.

2. The Plaintiff excepts to the Special Master's finding that Congress was presented with competent proof that bearer bonds posed a tax compliance problem which

is substantially reduced by the challenged registration requirements and that the registration is necessary to achieve the congressional objective.

3. The Plaintiff excepts to the Special Master's finding that opposition to the registration requirement and the penalty of subjecting the states' bonds to a tax was not a priority matter with the Plaintiff.

4. The Plaintiff excepts to the Special Master's finding that the municipal bond market in all probability would have moved to a registered book entry system on its own even if TEFRA had not been enacted.

5. The Plaintiff excepts to the Special Master's finding that the rate of increase

in borrowing has not been slowed by the challenged statute.

6. The Plaintiff excepts to the Special Master's finding that the registration requirement applies to the form and not the substance of the Plaintiff's bond issues.

7. The Plaintiff excepts to the Special Master's finding that the form of bond issues has little intrinsic value to the states.

8. The Plaintiff excepts to the Special Master's finding that the increased cost and burden of registration is not so onerous as to interfere with the operation of local governments.

9. The Plaintiff excepts to the Special Master's finding that the Plaintiff failed to prove investor preference for bearer municipal bonds.

10. The Plaintiff excepts to the Special Master's finding that there was no interest rate differential between bearer and registered bonds.

11. The Plaintiff excepts to the Special Master's finding that Congress' conclusion that registration may facilitate tax avoidance and income concealment "seem altogether reasonable."

12. The Plaintiff excepts to the Special Master's finding that the registration requirement has not had any substantive effect on the ability of the states and localities to raise debt capital.

13. The Plaintiff excepts to the Special Master's finding that TEFRA has had no effect on the political processes by which a state decides to issue debt.

14. The Plaintiff excepts to the Special Master's finding that TEFRA has not changed how much the states borrow, for what purposes they borrow, how they decide to borrow, or other important aspects of the borrowing process.

15. The Plaintiff excepts to the Special Master's failure to define the scope of judicial inquiry concerning whether the registration requirement was necessary to achieve a legitimate purpose.

16. The Plaintiff excepts to the Special Master's finding that the testimony supports the belief that a "not

insubstantial number of investors prefer bearer bonds because they facilitate tax evasion and concealment of illegal income," the error being there was no competent proof to support such a finding.

17. The Plaintiff excepts to the Special Master's finding that "seemingly the states accepted federal regulations dealing with arbitrage and industrial development bonds as the price of their ability to minimize their own interest costs."

18. The Plaintiff excepts to the Special Master's finding that the history of state acquiescence weakens the states' contention that requiring registration is destructive of their sovereignty and that the political process failed to perform as intended.

19. The Plaintiff excepts to the Special Master's finding that the registration requirement was non-discriminatory.

20. The Plaintiff excepts to the Special Master's conclusion that the tax sanction of TEFRA registration does not violate the doctrine of intergovernmental tax immunity.

21. The Plaintiff excepts to the Special Master's conclusion that the tax sanction of TEFRA's registration requirement does not violate the Tenth Amendment.

22. The Plaintiff excepts to the Special Master's conclusion that the tax sanction of TEFRA's registration requirement does not violate our notions of Federalism.

23. The Plaintiff excepts to the Special Master's conclusion that the tax sanction of TEFRA's registration requirement does not violate the Sixteenth Amendment.

24. The Plaintiff excepts to the Special Master's conclusion that the sponsors of the Sixteenth Amendment did not contemplate incorporating intergovernmental tax immunity, the error being the question is whether the states in ratifying the Sixteenth Amendment understood the states' tax immunity would be preserved in the Sixteenth Amendment.

25. The Plaintiff excepts to the Special Master's conclusion that the tax sanction is not an impermissible regulatory tax.

26. The Plaintiff excepts to the Special Master's conclusion that the compliance

burdens of TEFRA do not constitute an impermissible tax.

27. The Plaintiff excepts to the Special Master's conclusion that the tax sanction does not burden the states' borrowing power.

28. The Plaintiff excepts to the Special Master's conclusion that the tax sanction does not violate the states' political process.

SUMMARY OF ARGUMENT

1. Application of the penalty provision of §103 offends the doctrine of reciprocal tax immunity recognized by Alexander Hamilton and the Drafters of the Constitution, Chief Justice Marshall in M'Culloch v. Maryland, 17 U.S. (4 Wheat.) 316 (1819), and this Court's explicit holding in Pollock v. Farmers' Loan & Trust Co., 157 U.S. 429 (1895). Further, the assertion of the taxing power by the National Government upon state bond proceeds is itself an unconstitutional abuse.

2. The states ratified the Sixteenth Amendment upon the understanding that the National Government could not tax the proceeds of state bond issues used to finance the operations of state government. Intergovernmental tax immunity, embodied in the precise holding of this Court in Pollock -- an income tax upon the proceeds of state bonds issued to finance state governmental operations is an

indirect tax upon the state and repugnant to the reserve powers of the state -- was incorporated into the Sixteenth Amendment. Thus, application of §103 violates the Sixteenth Amendment.

3. The Tenth Amendment reserves to the states powers not delegated to the national government, and "unquestionably" preserves unto to the states "a significant measure of sovereign authority." Garcia v. San Antonio Metropolitan Transit Authority, 469 U.S. 528, ___, 105 S. Ct. 1005, 1017 (1985) (quoting from EEOC v. Wyoming, 460 U.S. 226, 269 (1983) (Powell, J., dissenting)). The ability to exercise freely the right to borrow money to fund core state governmental operations is an essential aspect of state sovereignty. A tax upon the income of state obligations is an indirect tax upon something Congress has no right to tax. The tax is no less repugnant to the Constitution merely because Congress

permits tax immunity if the state issues its debt upon conditions acceptable to Congress. If Congress can legislate conditions for tax immunity, the states enjoy not a tax immunity, but a tax exemption issued at the prerogative of Congress.

4. The State has a protected right under its reserve powers expressed in the Tenth Amendment and embraced in our notion of Federalism and in the Sixteenth Amendment to issue debt instruments without subjecting its bond proceeds to federal taxation. Congress does not bestow this right upon the State; and it cannot condition its free exercise upon onerous penalties which make its free exercise a hollow right. The Tenth Amendment, as part of the Bill of Rights, affords the State protection of its sovereignty. As such, this Amendment parallels the protection of personal liberties embraced in earlier amendments. Congress' attempt to shackle the State's

exercise of its sovereignty by exacting a penalty deprives the State of its sovereignty and is repugnant to the Constitution, in the same way that deprivations of free exercise of speech, religion or other rights in the Bill of Rights are effected by imposing conditions and penalties.

5. This Court is asked by the National Government to sanction its intrusion into an essential exercise of state sovereignty upon the premise that the intrusion is limited and even-handed and that modern national problems require flexible responses. The intrusion is discriminatory and the regulation unnecessary to achieve its objectives. Moreover, the National Government's position is no more than that of an offer of the forbidden fruit. History teaches us to respect and fear the human tendency to concentrate power. An acute appreciation of the tendency to centralize authority inspired the Constitutional Framers

to adopt the Bill of Rights for the precise purpose of thwarting that tendency.

6. Congress has attempted to dominate the states through its interpretation of the Sixteenth Amendment to limit the states' tax immunity, and its inherent competition with the states to raise revenue independently. The political procedural safeguards of the Constitution discussed in Garcia, 469 U.S. at ___, 105 S. Ct. at 1018-19, are inadequate to protect the states. Recent political debate makes clear the National Government wishes to assert its ability to tax the proceeds of state bond issues and restrict the amount of state debt which may be issued "tax exempt by Congress." Congress has enacted a so-called minimum tax which includes within the definition of income the interest on state bonds. Social Security Amendments of 1983, Pub. L. No. 98-21, §121, 97 Stat. 65. In The Tax Reform Act of 1986, P.L. 99-518, the

National Government asserts the authority to tell the states how much debt they may issue exempt from federal taxation and for what purposes the debt may be issued tax- exempt. The Court's admonition in United States v. Baltimore & Ohio Railroad Co., 84 U.S. (17 Wall.) 322, (1872) rings true:

> If they may be taxed lightly, they may be taxed heavily; if justly, oppressively. Their operation may be impeded and may be destroyed if any interference is permitted. Hence, the beginning of such taxation is not allowed on the one side, is not claimed on the other.

Id. at 327-28.

7. When the National Government exercises its taxing power, Garcia and cases interpreting Congress' power under the commerce clause are not analogous. Congress, if it so desires, can allocate to itself exclusive authority to regulate interstate commerce. However, the power to tax is neither the

exclusive domain of the states nor the federal government.

8. The danger the states face from the National Government is not obliteration. Rather, it lies in the "tyranny of small decisions" which rob the states of their independence and ultimately reduces them to meaningless administrative arms of the National Government. Our notion of Federalism commands respect for the states. "It is one of the happy incidents of the federal system that a single courageous state may, if its citizens choose, serve as a laboratory; and try novel social and economic experiments without risk to the rest of the country." New State Ice Co. v. Liebmann, 285 U.S. 262, 311 (1932) (Brandeis, J., dissenting). The roots of Federalism are based on the recognition that the people are the ultimate source of sovereignty; they can best exercise that authority in the state houses, county courthouses and city halls

scattered throughout the country. Section 103 impinges upon the authority of the states and their people to exercise sovereign state powers.

9. As a basis for upholding the penalty imposed by §103(j) of TEFRA, the Master concluded that other regulations enacted by the National Government relating to industrial development bonds and arbitrage bonds are more intrusive upon the exercise of the State's sovereignty, and had not been challenged by the states. Apparently, the Master believes the State of South Carolina has relinquished its sovereignty and its right to timely challenge the current statute. If the Master's analysis of acquiescence or estoppel to assert constitutionally protected rights is correct, a multitude of citizens protected by constitutional provisions against racial discrimination and voting rights would be barred from relief in federal court. The

Master's premise that the State forfeits its sovereignty unless it challenges all legislation impinging upon that sovereignty would necessitate litigation simply to preserve sovereignty, even if the state had not disagreed with the judgment exercised by the National Government in enacting certain regulations.

10. The Master's reliance upon the State's failure to challenge industrial development bond regulations and arbitrage bond regulations is misplaced. Whether taxation of so-called private activity development bonds or arbitrage provision is cognizable under the Pollock test, the Tenth or Sixteenth Amendments call for an inquiry beyond the issues presented by the pleadings. Finally, the Master's intrigue with the inferences to be drawn by the lack of litigation concerning challenges to other statutes regulating tax exemptions fails to appreciate the procedural hurdles to

litigation. Indeed, the National Government began its resistance to consideration of the merits in the pending action by claiming lack of authority of even this Court to entertain the action. South Carolina v. Regan, 465 U.S. 367 (1984).

ARGUMENT

I. SECTION 310 (b) (1) OF THE ACT VIOLATES THE UNITED STATES CONSTITUTION BY SUBJECTING THE INTEREST PAID ON DEBT OBLIGATIONS ISSUED BY SOUTH CAROLINA TO FEDERAL INCOME TAXATION.

Imposition of a tax pursuant to Section 310 as a penalty violates the doctrine of intergovernmental tax immunity and the teaching of Pollock v. Farmers' Loan & Trust Co., 157 U.S. 429, vacated on other grounds on reh'g, 158 U.S. 601 (1895). Ratification of the Sixteenth Amendment was accomplished upon the states' understanding that the protection against federal taxation of state bond proceeds was incorporated into the Sixteenth Amendment. In order for the Court to evaluate the application of the intergovernmental tax immunity doctrine, the incoporation of that doctrine into the Sixteenth Amendment and the issue of whether Congress may condition state immunity from taxation upon restrictions

relating to the states' right to freely borrow for their operations, in this brief South Carolina reviews applicable declarations contemporaneous with the adoption of the Constitution describing the permissible relationships between the national and state governments, decisions of this Court concerning intergovernmental tax immunity, the history of the adoption of Amendment Sixteen, and decisions of this Court defining the limits of intergovernmental tax immunity since the adoption of Amendment Sixteen.

A. Eighteenth Century Declarations by Drafters of United States Constitution.

> Money is, with propriety, considered as the vital principle of the body politic; as that which sustains its life and motion and enables it to perform its most essential functions. A complete power, therefore, to procure a regular and adequate supply of revenue, as far as the resources of the community will permit, may be regarded as an indispensable ingredient in every constitution. From a

> deficiency in this particular, one of two evils must ensue; either the people must be subjected to continual plunder, as a substitute for a more eligible mode of supplying the public wants, or the government must sink into a fatal atrophy, and, in a short course of time, perish.

THE FEDERALIST No. 30, at 188 (A. Hamilton) (Mentor ed. 1961).

Alexander Hamilton wrote these words to urge the adoption of the United States Constitution. The source of the Confederation's revenues was limited by the Articles of Confederation to requisitions from the states. Id.

Speaking for the drafting convention, Hamilton defended the concurrent revenue-raising powers of the national government and of the states, stating:

> The convention thought the concurrent jurisdiction preferable to that subordination; and it is evident that it has at least the merit of reconciling an indefinite constitutional power of taxation in the federal government with an adequate and independent power in the

> States to provide for their own necessities. . . .

Id. No. 34, at 211 (A. Hamilton).

He was aware of the possibility of friction between the two governments, each with a sovereign revenue-raising power:

> The particular policy of the national and of the State systems of finance might now and then not exactly coincide, and might require reciprocal forbearances. It is not, however, a mere possibility of inconvenience in the exercise of powers, but an immediate constitutional repugnancy that can by implication alienate and extinguish a pre-existing right of sovereignty.

Id. No. 32, at 200 (A. Hamilton) (emphasis added).

Hamilton recognized that the national and state governments would exercise their revenue-raising powers primarily through taxation and through borrowing. The unfettered exercise of both types of revenue-raising measures was essential.

B. Nineteenth Century Judicial Decisions.

In M'Culloch v. Maryland, 17 U.S. (4 Wheat.) 316 (1819), the Court held that Maryland had no authority to tax a bank chartered by Congress. Chief Justice Marshall enunciated the oft-quoted principle "[t]hat the power to tax involves the power to destroy." Id. Maryland's taxing power had to be measured by the extent of sovereignty that the people of Maryland possessed and could confer on their government; accordingly, Maryland could not tax what it could not exercise sovereignty over. By adopting that principle, the Chief Justice declared:

> We are not driven to the perplexing inquiry, so unfit for the judicial department, what degree of taxation is the legitimate use, and what degree may amount to the abuse of the power. The attempt to use it on the means employed by the government of the Union, in pursuance of the constitution, is itself an abuse, because it is a usurpation

> which the people of a single state cannot give.

Id. at 430 (emphasis added).

Weston v. The City Council of Charleston, 27 U.S. (2 Pet.) 481 (1829), was the first decision expressly holding that a tax imposed by one sovereign on the obligations or securities of the other is unconstitutional. Again Chief Justice Marshall, speaking for a majority of the Court, invalidated the Charleston ordinance imposing a tax on the stock of the United States for the repayment of loans:

> Congress has power "to borrow money on the credit of the United States." The stock it issues is the evidence of a debt created by the exercise of this power. The tax in question is a tax upon the contract subsisting between the government and the individual. It bears directly upon that contract, while subsisting and in full force. The power operates upon the contract the instant it is framed, and must imply a right to affect that contract.
>
> . . .
>
> If the right to impose the tax exists, it is a right which in its

> nature acknowledges no limits. It may be carried to any extent within the jurisdiction of the State or corporation which imposes it, which the will of each State and corporation may prescribe.

Id. at 465-66 (emphasis added).

Marshall reiterated the M'Culloch principle: the extent of a state's taxing power is measured by the extent of its sovereignty. Thus, a contract made by the national government in the exercise of its delegated borrowing power "is undoubtedly independent of the will of any State in which the individual who lends may reside." Id. at 467.

Charleston contended a direct attempt to oppose the national government's borrowing power such as an ordinance prohibiting loans to the United States would be invalid, but an attempt which may merely "consequentially affect it," id., was allowable. Marshall declared:

> It is not the want of original power in an independent sovereign State, to prohibit loans to a foreign government, which restrains the Legislature from direct opposition to those made by the United States. The restraint is imposed by our Constitution....
>
> The right to tax the contract to any extent, when made, must operate upon the power to borrow before it is exercised, and have a sensible influence on the contract. The extent of this influence depends on the will of a distinct government. To any extent, however inconsiderable, it is a burden on the operations of government. It may be carried to an extent which shall arrest them entirely.

Id. at 468 (emphasis added).

Perhaps most significant to South Carolina's challenge to the TEFRA penalty tax is the Chief Justice's discussion of the difference between the tax Charleston sought to impose on United States stocks issued for loan repayments and a tax on lands sold by the United States:

> It is admitted by the counsel for the defendants, that the power to tax stock must affect the terms on which loans will be made; but this

> objection, it is said, has no more weight when urged against the application of an acknowledged power to government stock, than if urged against its application to lands sold by the United States.
>
> The distinction is, we think, apparent. When lands are sold no connection remains between the purchaser and the government. The lands purchased become a part of the mass of property in the country with no implied exemption from common burdens. All lands are derived from the general or particular government, and all lands are subject to taxation. Lands sold are in the condition of money borrowed and repaid. Its liability to taxation in any form it may then assumed is not questioned. The connection between the borrower and the lender is dissolved. It is no burden on loans, it is no impediment to the power of borrowing, that the money, when repaid, loses its exemption from taxation. But a tax upon debts due from the government, stands, we think, on very different principles from a tax on lands which the government has sold.

Id. at 468-69 (emphasis added).

Finally, countering Charleston's assertion that a tax on stock came within the M'Culloch exceptions, the Chief Justice concluded:

> We do not think so. The Bank of the United States is an instrument essential to the fiscal operations of the government, and the power which might be exercised to its destruction was denied. But property acquired by that corporation in a State was supposed to be placed in the same condition with property acquired by an individual.
>
> The tax on government stock is thought by this court to be a tax on the contract, a tax on the power to borrow money on the credit of the United States, and consequently to be repugnant to the Constitution.

Id. at 469 (emphasis added).

Decisions uniformly invalidated the national government's attempt to tax the property or revenues of the states United States v. Railroad Company, 84 U.S. (17 Wall.) 322 (1872), to tax the salaries of state government officials, Collector v. Day, 78 U.S. (11 Wall.) 113 (1871); and the states' attempt to tax the salaries of United States employees. Dobbins v. Commissioners of Erie County, 41 U.S. (16 Pet.) 435 (1842).

These discussions recognized inherent sovereignty between the state and national government which must be respected. The Court was guided by the principle that:

> If they may be taxed lightly, they may be taxed heavily; if justly, oppressively. Their operation may be impeded and may be destroyed if any interference is permitted. Hence, the beginning of such taxation is not allowed on the one side, is not claimed on the other.

84 U.S. at 327-28.

C. The Pollock Decision

In Pollock the Court reviewed the constitutionality of a provision of the Revenue Act of 1894 which imposed a tax on the interest paid on State obligations. The Court concluded:

> The law under consideration provides "that nothing herein contained shall apply to states, counties or municipalities." It is contended that, although the property or revenues of the states or their instrumentalities cannot be taxed, nevertheless the income derived from

state, county, and municipal securities can be taxed. But we think the same want of power to tax the property or revenues of the states or their instrumentalities exists in relation to a tax on the income from their securities, and for the same reason; and that reason is given by Chief Justice Marshall, in Weston v. City Council, 2 Pet. 449, 468, where he said: "The right to tax the contract to any extent, when made, must operate upon the power to borrow before it is exercised, and have a sensible influence on the contract. The extent of this influence depends on the will of a distinct government. To any extent, however inconsiderable, it is a burthen on the operations of government. It may be carried to an extent which shall arrest them entirely. * * * The tax on government stock is thought by this court to be a tax on the contract, a tax on the power to borrow money on the credit of the United States, and consequently to be repugnant to the constitution." Applying this language to these municipal securities, it is obvious that taxation on the interest therefrom would operate on the power to borrow before it is exercised, and would have a sensible influence on the contract, and that the tax in question is a tax on the power of the states and their instrumentalities to borrow money, and consequently repugnant to the constitution.

157 U.S. at 585-586 (emphasis added).

Justice Field concurred: "[t]hese bonds and securities are as important to the performance of the duties of the state as like bonds and securities of the United States are important to the performance of their duties, and are as exempt from ..., taxation...." Id. at 601. Justice Field quoted Judge Cooley from The Principles of Constitutional Law that "[t]he constitution contemplates no such shackles upon state powers, and by implication forbids them." Id. at 602 (emphasis added).

While there were dissents as to other portions of the Court's holdings, the dissenters agreed with the majority on the issue of the tax-exempt nature of State obligations. Id. at 651 (White, J., dissenting); Id. at 654 (Harlan, J., dissenting). "[I]t is immaterial to inquire whether the tax is, in its nature or by its operation, a direct or an indirect tax; for the

instrumentalities of the states ... are not subjects of national taxation in any form or for any purpose.... Id.

The holding of Pollock was that:

> We have unanimously held in this case that, so far as this law operates on the receipts from municipal bonds, it cannot be sustained, because it is a tax on the power of the states and on their instrumentalities to borrow money, and consequently repugnant to the constitution.

158 U.S. 601, 630.

Likewise, the statement of Justice Brown, in dissent:

> The tax upon the income of municipal bonds falls obviously within the other category, -- of an indirect tax upon something which congress has no right to tax at all, -- and hence is invalid.

Id. at 693.

The bedrock of the Constitution melded the reciprocal tax immunity doctrine adopted in Pollock: (1) an unrestricted revenue-raising power was essential to the creation and

continued existence of the national government; (2) an equally complete revenue-raising power was necessary to maintain the states' sovereignty; (3) the national and state systems of finance might not always coincide and the co-equal nature of the revenue-raising power would necessitate reciprocal restraints when friction occurred; and (4) the borrowing power and the revenue-raising power were essential.

In recognition of the constitutionally mandated relationship between the national and State government, the court had concluded: (1) the complete revenue-raising power vested in both the national and the state governments meant that neither sovereign could tax the other; (2) interest paid on obligations issued by the sovereign was included in the reciprocal tax immunity as a tax on the contract between the borrower and the lender; and (3) one sovereign's <u>attempt</u>, without more, to impose a tax on the interest paid on the other's

obligations violated the reciprocal tax immunity doctrine; because the assertion of the taxing power by the one was itself an unconstitutional burden on the other.

D. Adoption of the Sixteenth Amendment.

In addition to declaring income on state bond issues immune from federal taxation, in Pollock the Court found the apportionment of income taxes between the states unconstitutional. President Taft urged Congress to adopt the Sixteenth Amendment since "(f)or the Congress to assume that the (Supreme) (C)ourt will reverse itself, and to enact legislation on such an assumption will not strengthen popular confidence in the stability of judicial construction of the Constitution." 44 Cong. Rec. 1548, 1568-69, 3377 (1909).

Amendment Sixteen provides:

> The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration. (emphasis supplied)

Congress adopted the proposal. The proposal to tax income "from whatever source derived" ignited an intense political debate in the ratification process. Governor Charles Evans Hughes of New York favored the apportionment provision, but assailed the phrase "from whatever source derived" claiming it may include "income derived from State and municipal securities." He cautioned that ratification of an amendment to the Constitution is "the most important of political acts," Appendix A to Plaintiff's Brief, and assent should not be given upon the basis the National government will apply a sound rule of construction. Hughes was particularly concerned that the amendment "will

be in effect a grant to the Federal government of the power which [it] defines." Id.

Amendment supporters in Congress decried Hughes' criticism as "unfounded and alarmist." 1/ Congressional and public debate ensued concerning the irrefutable logic and dogma of Pollock which immunized the income of state bond proceeds from federal taxation. Thereafter, the amendment was ratified by the required three-fourths of the states. The legislative history makes clear the assent by the states was materially induced by recognition that the amendment embodied the Pollock decision. Id.

The Special Master opined: "...[T]he principal sponsors of the Sixteenth Amendment took pains to assure the Congress that passage of the Sixteenth Amendment would not, in and of

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1/ Amicus curiae brief of the Government Finance Officers Association contains a comprehensive discussion of the adoption of the Amendment.

itself, authorize federal taxation of municipal bonds." Report at 163 n. 463.

E. Twentieth Century Judicial Decisions.

In Brushaber v. Union Pacific Railroad Co., 240 U.S. 1 (1916), the Court rejected the claim that the Sixteenth Amendment broadened the sources of income which could be constitutionally taxed by the United States. After reviewing the history of the ratification of the Sixteenth Amendment and its relation to Pollock, id. at 12-17, the Court concluded that the Sixteenth Amendment did not have the effect of expanding the federal taxing power and

> that the whole purpose of the Amendment was to relieve all income taxes when imposed from apportionment from a consideration of the source whence the income was derived . . . . [It was] not to change the existing interpretation except to the extent necessary to accomplish the result intended (emphasis supplied).

Id. at 17-18; see also Stanton v. Baltic Mining Co., 240 U.S. 103, 112 (1916); Evans v. Gore, 253 U.S. 245, 260-64 (1920).

In more than one hundred years since Pollock the Court has decided several cases involving reciprocal tax immunity. In not one of those cases, however, has Pollock been questioned either expressly or by implication until the dissent of Justice Stevens here. South Carolina v. Regan, 465 U.S. 367, 399-406 (1984). The doctrine of stare decisis is not rigidly applied to constitutional questions, but "any departure from the doctrine of stare decisis demands special justification." Arizona v. Rumsey, 467 U.S. 203, 2112 (1984); see also Oregon v. Kennedy, 456 U.S. 667, 691-92 n. 34 (Stevens, J., concurring); Garcia v. San Antonio Metro Transit Authority, 469 U.S. ___, 105 S. Ct. at 1022 (Powell, J., dissenting).

Several post Pollock decisions have held the doctrine of tax immunity inapplicable to subsequent Congressional enactments. None involves the basic fiscal and revenue power of the state. Each offers rationale without disavowing the constitutional basis upon which Pollock was premised. When the state functions as an economic competitor in the arena of commerce, either as a contractor, lessor, or employer or when taxation of bonds does not relate to the initial bond contract between the state and purchaser, but the subsequent sale, gift or inheritance of the bond and the bond has become an item of commerce, state immunity from federal taxation is generally not applicable.

In 1926, the Court held that the United States could tax the income received by an independent contractor from a contract with a state. Metcalf & Eddy v. Mitchell, 269 U.S. 514 (1926) Citing Weston and Pollock, the Court declared:

> But this court has repeatedly held that those agencies through which either government immediately and directly exercises its sovereign powers, are immune from the taxing power of the other. Thus. . ., its obligations sold to raise public funds. . ., are. . . so intimately connected with the necessary functions of government, as to fall within the established exemption; and when the instrumentality is of that character, the immunity extends not only to the instrumentality itself but to income derived from it. . . .

Id. at 522.

The Court concluded an independent contractor used his property or derived profits in dealings with the government but was not "an instrumentality of government within the [tax immunity] rule." Id. at 523. Taxing an independent contractor's earnings from government contracts did not impair the ability of the State to procure the services of private individuals. Id. at 526. The Court continued to recognize the existence of functions altogether beyond the taxing power:

> While it is evident that in one aspect the extent of the exemption must finally depend upon the effect of the tax upon the functions of the government alleged to be affected by it, still the nature of the governmental agencies or the mode of their constitution may not be disregarded in passing on the question of tax exemption; for it is obvious that an agency may be of such a character or so intimately connected with the exercise of a power or the performance of a duty by the one government, that _any_ taxation of it by the other would be such a direct interference with the functions of government itself as to be plainly beyond the taxing power.
>
> _It is on this principle that_, as we have seen, _any taxation by one government of_ . . . _the public securities of the other_. . . _is prohibited_.

_Id_. at 524 (citation omitted and emphasis added).

In _Willcuts v. Bunn_, 282 U.S. 216 (1931), the Court upheld a capital gains tax imposed by the United States on gains from sales of municipal bonds. After reviewing _Pollock_ with approval, the Court differentiated the capital gains tax from a tax on interest from those bonds:

> The sale of the bonds by their owners, after they have been issued by the State or municipality, is a transaction distinct from the contracts made by the government in the bonds themselves, and the profits on such sales are in a different category of income from that of the interest payable on the bonds.... The tax upon interest is levied upon the return which comes to the owner of the security according to the provisions of the obligation and without any further transaction on his part. The tax falls upon the owner by virtue of the mere fact of ownership, regardless of use or disposition of the security. The tax upon profits made upon purchases and sales is an excise upon the result of the combination of several factors, including capital investment and, quite generally, some measure of sagacity....

Id. at 226-28.

In James v. Dravo Contracting Co., 302 U.S. 134 (1937), the Court made the Metcalf & Eddy holding reciprocal by sustaining a state tax on the income of an independent contractor of the United States. The Court continued to accept Pollock:

> There is no ineluctable logic which makes the doctrine of immunity with respect to government bonds applicable to the earnings of an independent contractor rendering services to the government. That doctrine recognizes the direct effect of a tax which "would operate on the power to borrow before it is exercised" (Pollock v. Farmers' Loan & Trust Co., supra), and which would directly affect the government's obligation as a continuing security. Vital considerations are there involved respecting the permanent relations of the government to investors in its securities and its ability to maintain its credit; considerations which are not found in connection with contracts made from time to time for the services of independent contractors.

Id. at 152-53.

In dissent, Justice Roberts characterized the reciprocal tax immunity cases beginning with M'Culloch. "Chief Justice Marshall denied the existence of the power. From that day to this the court has consistently held that the question is not one of quantum, not one of the weight of the burden, but one of power. . . . Id. at 181 (emphasis added).

In Helvering v. Mountain Producers Corp., 303 U.S. 376 (1938), the Court upheld the United States tax on a corporation's income from property it leased from a state. It noted Pollock involved a tax on the interest paid on state obligations -- a tax "bearing directly upon the exercise of the borrowing power of the government" -- and not a capital gains tax a tax on "a transaction distinct from the contracts made by the government in the bonds themselves." Id. at 386.

The same year, in Helvering v. Gerhardt, 304 U.S. 405 (1938), the Court sustained a federal tax on the salaries of state employees. Again, it distinguished the tax from one imposed on a function "essential to the maintenance of a state government: as where the attempt was. . . to tax income received by a private investor from state bonds, and thus threaten impairment of the borrowing power. . . ." Id. at 417.

The Court enunciated two principles of limitation to hold the states' tax immunity to its proper function: first, excluded from tax immunity are activities thought not to be essential to the preservation of state government; and, second, excluded from tax immunity are those taxes laid on individuals where the burden on the state is speculative and uncertain. Id. at 419-20.

Graves v. New York ex rel. O'Keefe, 306 U.S. 466 (1939), made Gerhardt reciprocal by upholding a state tax on the income of United States employees. The "single" question decided was whether a state tax on the salary of an employee of a United States corporation (Home Owners' Loan Corporation) imposed an unconstitutional burden on the national government. Id. at 477. Weston and Pollock were not mentioned in the majority opinion.

In New York v. United States, 326 U.S. 572 (1946), the Court upheld a United States tax on

New York's mineral water sales, finding that New York was not immune from a non-discriminatory federal excise tax. The decision was a splintered one, but, as Justice Rutledge observed, "[a]ll agree that not all of the former immunity is gone." Id. at 584. Justice Frankfurter's majority opinion favored a restrictive tax immunity, allowing it only if the tax imposed discriminated against the state. He recognized an irreducible core of tax immunity:

> There are, of course, State activities and State-owned property that partake of uniqueness from the point of view of intergovernmental relations. These inherently constitute a class by themselves. Only a State can own a Statehouse; only a State can get income by taxing. These could not be included for purposes of federal taxation in any abstract category of taxpayers without taxing the State as a State.

Id. at 582.

The two dissenters -- Justices Douglas and Black -- expressly referred to the issuance of

debt obligations as protected by the tax immunity doctrine. Id. at 591, 593, 595. They argued "[t]he Constitution is a compact between sovereigns. The power of one sovereign to tax another is an innovation so startling as to require explicit authority if it is to be allowed." Id. at 595 (emphasis added).

In Massachusetts v. United States, 435 U.S. 444 (1978), the Court determined that a federal flat-fee registration tax (amounting to $131.43 in 1973) on state aircraft was in the nature of a user fee. 2/ Without discussing the more recent decisions' treatment of Weston and Pollock, the Court concluded the more recent decisions produced a "practical construction" of the tax immunity doctrine: neither the taxing power of the government

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2/ Justice Brennan's tax immunity discussion was joined by a plurality; the concurring and dissenting opinions felt the discussion on tax immunity was unnecessary because of the user fee holding. 435 U.S. at 471-72 (Rehnquist, J., dissenting).

imposing the tax nor the "appropriate exercise of the functions of the government _affected_ by it" can be impaired. _Id_. at 459 (quoting from _New York v. United States_, 326 U.S. at 589-90) (emphasis added). A tax is valid if the subject of the tax is a "natural and traditional source of federal revenue" and if it is "inconceivable" that the tax could "ever" operate to preclude traditional state activities. _Id_. at 459-60.

The Court reminded us that "the existence of the States implies some restriction on the national taxing power." _Id_. at 454. Further the Court quoted from _New York v. United States_ that "limitation [on state sovereignty] cannot be so varied or extended as seriously to impair. . . the appropriate exercise of the functions of the government affected by it." _Id_. at 459.

F. <u>Section 103 offends the test articulated in New York v. United States and Massachusetts v. United States</u>

If the test enunciated in <u>New York v. United States</u> and in <u>Massachusetts v. United States</u> applies here, Section 310(b)(1) fails that test. The tax immunity for interest paid on state obligations does not withdraw a traditional source of revenue from the United States. Section 310(b)(1) also imposes a tax on states discriminatory in its impact. Both private issuers and the United States had already chosen to issue registered bonds before the enactment of Section 310 (b)(1). States and their instrumentalities were the only issuers forced by Section 310(b)(1)'s sanction to issue registered bonds.

The pending action is the first case since <u>Pollock</u> directly involving an attempt by the National Government to tax the interest paid by a state to the purchaser of its bond. Although

the doctrine has been refined, Weston and Pollock remain intact. Indeed, the Court expressly cited Weston with approval as recently as 1983 in American Bank and Trust Co. v. Dallas County, 463 U.S. 855, 870 (1983); see also First National Bank of Atlanta v. Bartow County Board of Tax Assessors, 105 S. Ct. 1516, 1522 (1985); cf. Pennhurst State School v. Halderman, 451 U.S. 1, 17 n. 13 (1981) ("There are limits on the power of Congress to impose conditions on the States pursuant to its spending power.")

The constitutional principles which inspired Pollock remain unchanged: (1) the revenue-raising power is vital to the continued existence of both the national and the state governments; (2) the national and state systems of finance have not always coincided and the co-equal nature of the revenue-raising power has necessitated reciprocal restraints when

friction has occurred; and (3) the borrowing power is as essential to the revenue-raising power as the taxing power.

Non-discriminatory user fee taxes upon the property of the state and taxation of income of employees of the state or federal government or independent contractors is permitted as not invading the essential attributes of state or federal sovereignty.

However, Federalism proscribes certain conduct: (1) the revenue-raising power vested in both sovereigns means that neither can directly tax the other; (2) a tax on interest paid on obligations issued by either government, as a tax on the contract between the borrower and the lender, directly taxes the issuer; and (3) the inability of either sovereign to tax the interest paid on obligations issued by the other results from the lack of power (or sovereignty) in that respect; for that reason, the attempt, without

more, by either sovereign to use such a taxing power burdens the other.

G. <u>Effect of Section 310(b)(1) on reciprocal tax immunity doctrine</u>.

By subjecting the interest paid on state obligations which are not in registered form to federal income taxation, Section 310(b)(1) has effectively precluded the states and their instrumentalities from issuing non-registered obligations. Justice Stevens in his dissent to the earlier opinion in this case observed: "As a practical matter, this requirement will force South Carolina to issue its bonds in registered form." 465 U.S. at 404. The taxation sanction is so severe that states are no longer able to issue their obligations in bearer form, the form they have preferred from the beginning. The record establishes that no bearer bonds have been issued since the effective date of the registration requirement. Report at 34.

That Section 310(b)(1)'s sanction has precluded the states and their instrumentalities from issuing taxable bearer bonds, however, does not alter its status as a tax. It is a tax that, because of its severity, will never be collected but it is nonetheless a tax. Indeed, Section 310(b)(1)'s "power to tax involves the power to destroy" the states' ability to issue bearer bonds. And because, as the Court has held since at least Weston, it operates directly on the states' borrowing power, it is a tax that the National Government is without authority to impose.

The increased costs (especially incurred by small issuers) as well as the higher interest rates caused by the registration requirement themselves work as a tax on the state issuer because the state issuer directly incurs them. While higher costs do not by themselves ordinarily constitute a tax, they do constitute a tax when they are incurred because

the alternative is an explicit tax so severe that it forces the issuer to comply.

H. <u>Section 103 taxes the State as a penalty when It exercises Its Constitutional rights</u>.

Enforcement of the registration requirement is achieved by imposing a tax for non-enforcement -- that is, Section 310(b)(1) directs the states and their instrumentalities to issue registered bonds or forfeit their immunity. The United States Congress, like all legislatures, cannot do by indirection what it cannot do directly. <u>See</u> <u>Maxwell v. Bugbee</u>, 250 U.S. 525, 543-44 (1919) (Holmes, J., dissenting).

The State has a constitutionally protected right under its reserved powers expressed in the Tenth Amendment embraced in our notion of Federalism and the Sixteenth Amendment to issue debt instruments without subjecting its bond

proceeds to taxation. Congress does not bestow this right upon the state; and it cannot condition its free exercise upon onerous penalties which make its free exercise a hollow right.

The Tenth Amendment is part of the Bill of Rights. It affords the State protection of its sovereignty which parallels the protection of personal liberties embraced in earlier amendments. Congress' attempt to condition South Carolina's right to the unfettered exercise of its sovereignty by exacting a penalty is repugnant to the Constitution, just as is a congressional attempt to deter the free exercise of speech or religion by imposing conditions and penalties. See Sherbert v. Verner, 374 U.S. 398, 404 (1963) (exclusion from unemployment benefits because plaintiff refused to work on Saturdays, due to her religion, was unconstitutional because governmental imposition of a choice between

adhering to religious beliefs and obtaining state benefits interferes with the free exercise of religion as would a fine imposed for Saturday worship); Elrod v. Burns, 427 U.S. 347, 360-61 (1976) (termination of public employees based on political affiliation violated the First Amendment by imposing an unconditional condition on the receipt of a public benefit); cf. Speiser v. Randall, 357 U.S. 513, 518 (1958) ("It cannot be gainsaid that a discriminatory denial of a tax exemption for engaging in speech is a limitation on free speech.").

The penalty Congress imposes upon the State is the same for Constitutional purposes as requiring a more severe criminal penalty upon conviction if a person exercises his right to a jury trial rather than submitting his case to a judge. Indeed, the justification for the penalty Congress imposes in TEFRA -- efficient operation of government -- would justify

relinquishment of most of our personal liberties enshrined in the Bill of Rights. The adoption of the Bill of Rights was never viewed as promoting the efficiency of government.

The guiding principle was set forth in Frost Trucking Co. v. Railroad Commission, 271 U.S. 583 (1926):

> It would be a palpable incongruity to strike down an act of state legislation which by words of express divestment, seeks to strip the citizen of rights guaranteed by the federal Constitution, but to uphold an act by which the same result is accomplished under the guise of a surrender of a right in exchange for a valuable privilege which the state threatens otherwise to withhold.

Id. at 593.

The Tenth Amendment was ratified in 1791 as part of the Bill of Rights. Eight states voted for the Constitution only after proposing amendments to be adopted after ratification. All eight proposals included some version of what became the Tenth Amendment. Garcia v. San Antonio Metropolitan Transit Authority, 469

U.S. at ___, 105 S. Ct. at 1027-28. Ratification was based upon the promise of dual sovereignty between the National and State government.

Chief Justice Stone stated it was intended "to allay fears that the new national government might seek to exercise powers not granted, and that the states might not be able to exercise fully their reserved powers." United States v. Darby, 312 U.S. 100, 124 (1941). The Tenth Amendment reserves powers not delegated "to the states respectively or to the people." Jefferson recognized "the true barriers of our liberty in this country are our State governments." D. Malone, Jefferson and the Ordeal of Liberty, 394 (1962).

If registration of state bond issues is desirable, there are means available to the United States Congress and to the Secretary of the Treasury to achieve registration -- means apparently not investigated or considered when

the current sanction was conceived. Chapoton Tr. 915-918. Those means would have achieved registration, at least in the opinion of the Assistant Treasury Secretary, who crafted the current sanction. Id. 917-918. [3] Unlike Section 310(b)(1), they do not erode the basic tenet of Federalism.

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[3] But even Mr. Chapoton admitted that a perfect system of tax collection is not possible for our federal system or even for the national government. Tr. at 921. Justice Butler, dissenting in Mountain Producers, observed:

> As to that principle [reciprocal tax immunity], the urgency of governmental demand for money does not justify yielding here.

303 U.S. at 387.

I. <u>Application of Section 103 arrogates unto Congress power which has no limits, and destroys the Constitutional Equipoise between the National and State Government</u>.

One theme has been constant through the history of the tax immunity doctrine from <u>The Federalist</u> to <u>Pollock</u>, the last case to treat the tax-exempt status of interest paid on government obligations: once allowed, the power to tax would have no limits. That is the reason for Marshall's warning that the power to tax involves the power to destroy. The Court later applied that warning to a statute such as Section 310(b)(1):

> [T]he power to destroy which may be the consequence of taxation is a reason why the right to tax should be confined to subjects which may be lawfully embraced therein, although it happens that in some particular instance no great harm may be caused by the exercise of the taxing authority as to a subject which is beyond its scope.

<u>Knowlton v. Moore</u>, 178 U.S. 41, 60 (1900).

The total want of power in the one sovereign to tax the obligations (including income therefrom) of the other sovereign, prevents even the attempt to tax because the attempt itself abuses the affected sovereign. The Court has so stated from Weston to Gerhardt.

Justices Douglas and Black, dissenting in New York v. United States, cautioned:

> A tax is a powerful, regulatory instrument. Local government in this free land does not exist for itself.... Local government exists to provide for the welfare of its people.... If the federal government can place the local governments on its tax collector's list, their capacity to serve the needs of their citizens is at once hampered or curtailed.

376 U.S. at 593. They went on:

> The power to tax is indeed one of the most effective forms of regulation. And no more powerful instrument for centralization of government could be devised.

Id. at 594.

These fears are apropos. The political dialogue surrounding the adoption of the Sixteenth Amendment assumes the interest upon state obligations would be protected against federal taxation. The amicus brief of the Government Finance Officers' Association aptly describes the congressional march away from the assurances given the states when ratification was proposed, to the recent congressional pronouncement that taxation of state bond interest income is debatable. Indeed, recent political debate makes clear the national government wishes to assert its ability to tax the proceeds of state bond issues. Amicus Curiae Brief of The Government Finance Officers Association.

Congress has enacted a so-called minimum tax, which includes within the definition of income the interest on state bonds. Social Security Amendments of 1983, Pub. L. No. 98-21, Section 121, 97 Stat. 65. The 1986 Tax Reform

Act, Pub. L. No. 99-514 limits the issuance of tax immune bonds for purposes and amounts approved by Congress. It refers to the "exemption" rather than the "immunity" of the States. Title XIII, Secs. 1301 Y _et seq_.

Professor Tribe has described the danger of Congressional encroachment upon State sovereignty:

> Of course, no one expects Congress to obliterate the states, at least not in one fell swoop. If there is any danger, it lies in the tyranny of small decisions -- in the prospect that Congress will nibble away at state sovereignty, bit by bit, until someday essentially nothing is left but a gutted shell.

L. Tribe, _American Constitutional Law_, Section 5-20, at 302 (1978).

J. _Garcia does not apply to Federal taxation of State bond proceeds_.

In _Garcia v. San Antonio Metropolitan Transit Authority_, 469 U.S. 528 (1985), the

Court upheld an act of Congress supported by the Commerce Clause which imposed federal minimum wage -- maximum hour provisions of the Fair Labor Standards Act to the states and their instrumentalities. The Special Master observed "Garcia altered the landscape of federalism jurisprudence, but left the judicial mapping of the new terrain of federalism to future cases." Report at 117.

In Garcia the Court concluded the political procedural safeguards in the Constitution protect the states' interests from overreaching congressional regulation pursuant to the Commerce Clause. The logic of Garcia is inapplicable to federal taxation of state bond income. First, history teaches us that the Framers conceded the necessity of concurrent jurisdiction between the federal and state governments to raise revenue. Hamilton concluded the states could not be treated as subordinate creatures in an area of taxation;

however, the Constitution grants power to the federal government to preempt the field of interstate commerce.

The Court has said "[p]erhaps the two most authoritative persons in the Convention, touching the Constitution, were Hamilton and Madison." Springer v. United States, 102 U.S. 586, 597 (1881), and that when the scope of a constitutional amendment is unclear, no inquiry is "more appropriate[ ], we think, than to the history of the times in the midst of which the provision was adopted." Reynolds v. United States, 98 U.S. 145, 162 (1879). In consideration of the Establishment Clause, the Court has paid particular deference to Jefferson's views upon the belief that "[c]oming as this does from an acknowledged leader of the advocates of the measure, it may be accepted almost as an authoritative declaration of the scope and effect of the amendment thus secured." Id. at 164.

No one doubts Hamilton's advocacy for a strong central government, but as to taxation, he stated:

> [y]et I am willing to allow, in its full extent, the justness of the reasoning which requires that the individual States should possess an independent and uncontrollable authority to raise their own revenues for the supply of their own wants. And making this concession, I affirm that (with the sole exception of duties in imports and exports) they would, under the plan of the convention, retain that authority in the most absolute and unqualified sense; and that an attempt on the part of the national government to abridge them in the exercise of it would be a violent assumption of power, unwarranted by any article or clause of its Constitution.

The Federalist No. 32 at 197-98 (Hamilton).

Second, the history of federal sensitivity to the burdens imposed upon state and local governments when Congress regulates commerce recited in Garcia is not present in the area of taxation. Because the two sovereigns are competing for revenues, it is folly to suggest that the political process affords the states

protection. Review of this Court's decisions since M'Culloch v. Maryland, reveals the friction between the federal and state governments in areas of taxation.

Third, in Garcia, the Court noted "[o]f course, we continue to recognize that the states occupy a special and specific position in our constitutional system..." 469 U.S. at ___, 105 S. Ct. at 1020. The states cannot be viewed as a monolithic lobbying group juxtaposed against the federal bureauacracy and Congress. When each State ratified the Constitution, it entered into a covenant to retain certain individual sovereignty. The Tenth Amendment was not just a collective bargaining agreement for the states to exercise as a union of states against the National Government.

This Court's recent decision in Pennzoil Co. v. Texaco, 107 S. Ct. 1519 (1987), quoting Younger v. Harris, 401 U.S. 37, 44 (1971),

speaks to our notions of federalism, and the respect necessary to be paid to each state:

> What the concept does represent is a system in which there is sensitivity to the legitimate interests of both State and National Governments, and in which the National Government, anxious though it may be to vindicate and protect federal rights and federal interests, always endeavors to do so in ways that will not unduly interfere with the legitimate activities of the States.

Id. at 1525-26 (quoting from Younger v. Harris, 401 U.S. 37, 44 (1971))

For the Court to abandon the holding of Pollock and sustain the challenged act would expand Justice Powell's concern expressed in Garcia that "[d]espite some genuflecting in Court's opinion to the concept of federalism, today's decision effectively reduces the Tenth Amendment to meaningless rhetoric when Congress acts pursuant to the Commerce Clause." 469 U.S. at ___, 105 S. Ct. at 1022 (Powell, J., dissenting). The challenged act is illustrative of Justice O'Connors observation

that "all that stands between the remaining essentials of state sovereignty and Congress is the latter's underdeveloped capacity for self-restraint." Id. at 1037.

The Court must decide whether "our federalism" will survive into the third century of the Constitution. The promise of dual sovereignty between the national government and the states was an essential part of the ratification process. The sovereignty retained by the states was their flagship against encroachment by the national government. The states must not be reduced to empty vessels traveling to Washington to lobby for those benefits and bounty the national government will bestow.

> Federalism is both a constitutional principle and a practical strategy for good government. It is not an antiquated idea. It makes good sense today, as it did two hundred years ago. Those who argue that any attempt at revitalizing federalism is doomed to failure -- because the problems of government today are so different from the kinds of problems

> confronting the Framers -- fail to recognize that while the particular issues differ, political principles that provide the foundation of those issues are the same.

The Status of Federalism in America: A Report of the Working Group on Federalism of the Domestic Policy Council 59 (1986).

Moreover, Federalism promotes Hobbes' notion that "freedom is political power divided into small fragments." S. Ervin, Preserving the Constitution 72 (1984). Woodrow Wilson observed that the "concentration of powers is what always precedes the destruction of human liberties." Id. at 73. Justice Powell wrote in dissent in Garcia:

> [T]he harm to the States that results from federal overreaching under the Commerce Clause is not simply a matter of dollars and cents. . . .Nor is it a matter of the wisdom or folly of certain policy choices. . . . Rather, by usurping functions traditionally performed by the States, federal overreaching. . . undermines the constitutionally mandated balance of power between the

> States and the federal government, a balance designed to protect our fundamental liberties.

469 U.S. at ___, 105 S. Ct. at 1029.

For the foregoing reasons, the Court must not cavort with the other branches of the national government and uphold Section 301 -- an Act which has taken more than the unconstitutional nibble feared by Tribe.

II. SECTION 310(b)(1) OF THE ACT VIOLATES THE TENTH AMENDMENT TO THE UNITED STATES CONSTITUTION BY REGULATING SOUTH CAROLINA'S POWER TO BORROW MONEY AND ITS RESERVED POWERS.

A. Section 310(b)(1) as impermissible burden and regulation of State's borrowing power.

The power to borrow money is an essential power of government. Smyth v. United States, 302 U.S. 329, 362-63 (1937) (Stone, J., concurring); Willcuts v. Bunn, 282 U.S. at 225; Weston v. The City of Charleston, 27 U.S. (2 Pet.) at 467. In Pollock, the Court held that

> under the fundamental law, as to the power to borrow money, neither the United States, on the one hand, nor the states on the other, can interfere with that power as possessed by each, and an essential element of the sovereignty of each.

157 U.S. at 585.

Bond issues are used to fund critical state projects. Nationally, over $500 Billion

of municipal bonds are outstanding. In 1974, $23 Billion worth of new municipal bonds were issued. In 1983, $83 Billion were issued. In 1984, $102 Billion of new municipal bonds were issued. STIPULATION OF FACTS Nos. 8-10. There are approximately 47,000 issuers of municipal bonds in the United States. These issuers include states, counties, parishes, boroughs, cities, townships, school districts, special purpose districts, authorities and commissions. Id. No. 11.

The share of state and local government spending covered by borrowing has assumed an ever more important role in the capital budgeting of state and local governments because of relative decreases in federal grants. Id. Nos. 4 and 108. For example, in South Carolina, excluding construction of highways and electrical generation facilities, 46% of the funds required for current capital projects will be provided by issuing state and

agency bonds. Only 3% of the funds necessary for these projects will come from the federal government. PL. EX. 132.

The borrowing power is closely associated with the power to tax. Both powers raise funds to carry on the essential operations of government. In South Carolina, while the operating budget is funded through taxes, the capital budget is largely dependent upon borrowing. Borrowing is as essential to the capital budget as taxes are to the operating budget. Patterson Tr. 428-429, 438-439.

Independence in the exercise of authority to fund the government is essential to an independent government. Interference with a funding source necessarily interferes with and threatens independent existence.

Section 310(b)(1) also works an undue interference with the states' sovereignty; it adds cost to state and local issuers of debt. The registration requirement imposed new costs

upon state and local issuers of public debt. These new costs include the cost of procuring and retaining a registrar and transfer agent for each bond issue. The registration requirement requires the state to keep a record of each holder of its outstanding bonds. Under the bearer system, it was not necessary to incur the cost of this record keeping. Additionally, it is necessary to hire a transfer agent. This transfer cost was not incurred under the bearer system. The cost of preparing and mailing interest checks is paid by the state under the registered system whereas it was not a cost to the state under the bearer system. In short, under the registration system the public issuer has been forced to pay costs which were not incurred under the bearer system. See, STIPULATION OF FACTS Nos. 14, 15, 18 and 19.

Most bond issues are in amounts of $10 Million or less. STIPULATION OF FACTS No. 13;

PL. In 1983, 76% of bond issues were in this category. Report at 21. The ongoing administrative costs for registered bonds exceed those for bearer bonds for issues of $10 Million or less. Report at 41 and 43. The Government Finance Research Center ["GFRC"] study, endorsed by the Defendant, found that registration raises ongoing administrative costs significantly over the life of those issues. Additionally, costs associated with paying interest and principal to bondholders have increased considerably for these issuers.

The Defendant urged the hardships and added expense could be diminished by pure book ntry system and statewide pooling arrangements. "However, the Secretary [Defendant] presented no evidence indicating any post-TEFRA increase in the use of these systems by smaller issuers." Report at 43-44.

The Defendant did not address whether such pooling arrangements would require state

constitutional amendments or statutory enactments. In FERC v. Mississippi, 456 U.S. 742, 761-62 (1982), the Court noted it had "never...sanctioned explicitly a federal command to the States to promulgate and enforce laws and regulations." The Special Master found in order to comply with TEFRA, the states were obligated to enact numerous statutory and administrative changes and expend "not insignificant" sums of money. Report at 36-40.

In South Carolina, considering all state issues regardless of size, average original issuance costs and ongoing administrative costs have increased under the registered system from $14.28/$1000 principal for bearer bonds issued from 1979 through 1982 to $24.41/$1000 principal for registered bonds issued subsequent to 1982. PL. EX. Nos. 149 and 150.

The registration requirement has also imposed a considerable interest rate penalty upon issuers of public debt. The interest

component of state and local borrowing is significant; for example, at rates prevailing in March, 1984, the interest paid on a debt due in 20 years represented approximately 70% of total payments. PL. EX. No. 126 at 14. The interest rate penalty burden is imposed upon state and local governments each time they go to market and throughout the life of those bonds issued after July 1, 1983.

Interest rates are affected by investor preference for bearer bonds. Prior to the registration requirement investors in South Carolina bonds were given a choice to hold either bearer or registered bonds. Fully 97% of all bonds were held in bearer form. The interest rate penalty caused by the registration requirement is estimated to range up to 25 basis points. Patterson Tr. 448-451.

Professor Leonard demonstrated a penalty of 5 to 15 basis points. 4/

The defendant's market witnesses estimated that there is no interest penalty. The defendant's expert, however, was unable to support that thesis. In fact, his data were ultimately used to corroborate Professor Leonard's findings. This penalty has resulted in added interest costs of $140 Million to $420 Million in one year and $4.2 Billion to $12.6 Billion over thirty years nationwide.

The National Government contends the Plaintiff failed to prove that investors preferred bearer bonds for valid reasons. It speculates the preference, if any, is based solely upon the investors desire to conceal capital gains, gift and estate income subject

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4/ The Master found against South Carolina on this point; however, he adopted a seemingly inconsistent position that although bond holders were given the opportunity to convert to registered form "only a tiny minority. . . chose to convert." Report at 23 n. 72.

to federal taxation. No competent proof was offered by the Defendant. The Master stated: "The dominance of bearer securities appears to have been due not to investor preference, but to the absence of an impetus or motivation to change." Report at 48.

The Master's assumption is unsupported by the record. Additionally, the analysis is flawed. It assumes the State has an obligation to expend money on a public relations campaign to convince the public to prefer registered bonds.

Registrated bonds have features which should commend them to many investors. Direct deposit of employee checks to banks, automatic withdrawal for periodic payments, and no stop electronic teller machines likewise have attractive features. Yet, it probably would not surprise this Court that many people do not use these services, although they may be more convenient. In the absence of proof, the

Plaintiff doubts the Court would assume all those who choose even more cumbersome methods of depositing or withdrawing money from banks and spending time in teller lines or paying bills by check rather than direct employee deductions do so for illegal purposes. The Defendant offered no competent proof to support the assumption.

B. Section 310(b)(1) as violative of states' political processes.

The Tenth Amendment guarantees to the states the power to establish and maintain their own separate and independent governments. Oregon v. Mitchell, 400 U.S. 112 (1970). Borrowing money is intimately tied to the states' political processes. In Garcia, the Court relied upon the political process in our federal system to ensure the continued

existence of the states. 469 U.S. at ___, 105 S. Ct. at 1018-19. Implicit in reliance on the democratic political process at the national level is protection of the democratic process at the state level. See U.S. CONST. art. IV, §4, cl. 1 ("The United States shall guarantee to every State in this Union a Republican Form of Government").

The political process includes choice among competing interests for limited resources. The decision to borrow money, the means employed to do so and the use made of the proceeds are inseparable from the political process. Future tax revenues are necessarily pledged for repayment, thus ultimately tying the power to borrow to the power to tax.

South Carolina performs its governmental functions and provides services and facilities through expenditure of money. Expenditures in the State are divided into two categories: operational and capital. The capital

expenditures are for public improvements which have a long-term life expectancy. The State and its political subdivisions construct public buildings, schools, highways and bridges for the conduct of government, education of its citizens and efficient and safe transportation of goods and services in the State. Patterson Tr. 428-429, 438-439.

The capital needs of the State of South Carolina are increasing. From 1981 to 1984, outstanding debt at the State level increased by $55 Million. PL. EX. 130. Nationally, considering only those facilities owned by state and local governments, an annual capital need of approximately $70.3 Billion (in 1982 dollars) must be financed by states and localities from their own resources through 1989. This represents a 52% increase over the current level of spending. Most of the increase in capital spending will need to be financed by borrowing. PL. EX. 126 at 1, 12; Report at 21.

The State determines its capital needs, the priority of those needs and the source of funding for those needs through a capital budget process. Every two years State agencies and departments submit capital budgets to the State Budget and Control Board which conducts hearings, receives testimony and studies the capital needs of the State. This process results in a capital budget which is submitted to the State Legislature.

The Legislature determines priorities and authorizes funding for these projects. The process is uniquely governmental. The needs, desires and resources of an entire community are raised, considered and given priority. Borrowing is the means to ensure the continued vitality of these functions. By Section 310(b)(1), Congress has invaded the central decision-making processes of local government.

The power to borrow money includes the power to determine the form of the debt. <u>See</u>

Free v. Bland, 369 U.S. 663, 666-67 (1962) (U.S. savings bonds). Section 310(b)(1) has completely pre-empted state exercise of this choice.

State sovereignty includes the power to make basic organizational and operational decisions, particularly in finance. Section 310(b)(1) removed the states' right to decide the form of bonds to issue; it eliminated their authority to tailor the form of issuance to fit the needs of issuers and investors. The requirement that debt be issued in registered form dictates the policy decision of the form of the debt to the governments charged with the authority to issue debt and the responsibility to repay it.

C. Section 310(b)(1) as regulatory tax.

The tax imposed on municipal bonds if not issued in registered form is a penalty. No

revenue is sought to be obtained by Section 310(b)(1). South Carolina v. Regan, Tr. Oral Arg. 20. The tax is an unconstitutional penalty. While the Court gives wide latitude to exercise of the taxing power, it cannot regulate where no revenue is raised. United States v. Kahriger, 345 U.S. 22, 28 (1953) overruled on other grounds, Marchetti v. United States, 390 U.S. 39, 58 (1968); Carter v. Carter Coal Co., 298 U.S. 238, 289 (1936); Child Labor Tax Case (Bailey v. Drexel Furniture Co.), 259 U.S. 20, 37-39 (1922); Hill v. Wallace, 259 U.S. 44, 65-68 (1922). In United States v. Kahriger, the Court upheld a tax upon wagering against an allegation that it was an invalid exercise of the taxing power because the tax was supportable as a revenue-raising enactment. In its opinion the Court cited Child Labor Tax Case, and Hill v. Wallace, with approval as to the following language:

> Penalty provisions in tax statutes added for breach of a regulation concerning activities in themselves subject only to state regulation have caused this Court to declare the enactments invalid.

345 U.S. at 31 (footnote omitted).

Congress has attempted to regulate the states through a tax device. Assuming the device (denial of tax-exemption to interest earned on state bonds) is not a revenue measure, but merely seeks to regulate an essential state activity, it is an invalid attempt to invoke the power of taxation.

D. <u>The Nature of Judicial Inquiry Into the State's Loss of Essential Attributes of Sovereignty</u>.

In <u>Garcia</u>, the Court said states "retai[n] a significant measure of sovereign authority," 469 U.S. at ___, S. Ct. at 1017 (quoting from <u>EEOC v. Wyoming</u>, 460 U.S. at 269 (Powell, J., dissenting)), but that authority is with

exceptions, usually "protected by procedural safeguards inherent in the structure of the federal system." Id. at ___, 105 S. Ct. at 1018. The Court found that the internal safeguards of the political process had resulted in Congress not overstepping its authority with respect to the states. Id. at ___, 105 S. Ct. at 1020.

Garcia dealt with the extent of Congress' power under the Commerce Clause, U.S. CONST. art. I, §8, cl. 3. In most respects, therefore, it is not applicable to the present controversy. The Commerce Clause grants broad authority to Congress to regulate the national economy. FERC v. Mississippi, 456 U.S. at 753-54. "It is elementary and well settled that there can be no divided authority over interstate commerce, and that the acts of Congress on that subject are supreme and exclusive." Missouri Pacific Railroad Co. v. Stroud, 267 U.S. 404, 408 (1925) (quoted in

Hodel v. Virginia Surface Mining and Reclamation Association 452 U.S. 264, 290 (1981)). Congress regulates the economy through exercise of the Commerce Clause authority. See Usery v. Turner Elkhorn Mining Co., 428 U.S. 1, 15 (1976) (Commerce Clause involves "legislative Acts adjusting the burdens and benefits of economic life"). This, presumably, prompted the Court to adopt a general rule, with important exceptions discussed later, of deferring to Congress as it has done in Commerce Clause cases not involving regulation of the states. In the present case Congress is acting pursuant to its taxing power. 5/ As argued earlier, the states also

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5/ The different treatment under the taxing power and the Commerce Clause power is illustrated by Hill v. Wallace, 259 U.S. 44 (1922), and Chicago Board of Trade v. Olsen 262 U.S. 1 (1923). In 1921, Congress enacted the Future Trading Act, which imposed a prohibitive tax on grain futures transactions that were not consummated on an exchange designated as a "contract market" by the Secretary of

have a sovereign taxing power. See New York v. United States, 326 U.S. at 576 n. 2.

To the extent Garcia can be applied to the instant case, the limitations upon federal power inherent in the federal system described there have been exceeded. The Court explicitly recognized that there are two kinds of substantive restraints on Congress' authority in this area. First, restraints designed to compensate for possible failings in the national political process, 469 U.S. at ___, 105 S.Ct. at 1019-1020, and, second, restraints which preclude a complete assumption of state authority. Id. at ___, 105 S.Ct. at 1020 (citing Coyle v. Oklahoma, 221 U.S. 559 (1911)).

Agriculture. The 1921 statute was held unconstitutional as an improper exercise of the taxing power in Hill, but its regulatory provisions were promptly re-enacted in the Grain Futures Act and upheld under the Commerce Clause power in Chicago Board of Trade. See Merrill Lynch, Pierce, Fenner & Smith v. Curran, 456 U.S. 353, 360-61 (1984).

A significant issue before the Court is the formulation a method to recognize such a failure, a method to test the efficacy of the process.

The usual inquiry for the judicial branch when confronted with a question of the exercise of Congress' authority under the Commerce Clause is whether Congress had a rational basis for finding that the object of regulation affected interstate commerce and, if so, whether the means chosen by Congress to regulate the object so affecting commerce are reasonable and appropriate. See, e.g. Heart of Atlanta Motel v. United States, 379 U.S. 241, 258 (1964).

The Defendant has argued the "rational relationship" test is the proper test to apply to the congressional action challenged here. It is not. First, the exercise of congressional authority under the Commerce Clause cannot be equated to the taxing power.

Second, when a state is the subject of regulation, competing principles of federalism recognized in Garcia must be protected.

When a statute is challenged as an undue burden on an activity granted constitutional protection, degree of inquiry is that which is necessary to protect the competing constitutional value from erosion. Austin v. New Hampshire, 420 U.S. 656, 662 (1975) (state tax). This consideration applies equally to the protection of individual liberties and to the maintenance of federalism. Id. A "standard of review substantially more rigorous," Id. at 663, than that applied to private businesses or different trades or professions is required.

To determine whether the political process performed as intended, the Court must look to the process itself.

E. <u>The Record Before Congress</u>

The record shows that the political process failed to perform as intended. The burdens imposed by Section 310(b)(1) were imposed by the vote of an uninformed Congress relying upon incomplete information.

Congress set forth three reasons for requiring registration of bearer bonds.

> (1) The Committee believes that a fair and efficient system of information reporting and withholding cannot be achieved with respect to interest-bearing obligations as long as a significant volume of long-term bearer instruments is issued. A system of book-entry registration will preserve the liquidity of obligations while requiring the creation of ownership records that can produce useful information reports with respect to both the payment of interest and the sale of obligations prior to maturity through brokers.
>
> (2) Furthermore, registration will reduce the ability of noncompliant tax-payers to conceal income and property from the reach of the income, estate, and gift taxes.

> (3) Finally, the registration requirement may reduce the volume of readily negotiable substitutes for cash available to persons engaged in illegal activities.

S. REP. No. 494, 97th Cong., 2d Sess. 242 (1982). JT. EX. No. 86.

These three reasons essentially track the testimony of Assistant Treasury Secretary Chapoton before the House Ways and Means Committee in support of the registration requirement. Mr. Chapoton testified he did not have any evidence supporting these asserted justifications other than anecdotes. Report at 84. The Master found there was no evidence in the record quantifying tax evasion. Id.

The first justification, promotion of a fair and efficient system of information reporting, is completely without support since information reporting on the sale of municipal bonds is precisely the same for bearer and registered bonds. Report at 84-86.

The second part of this justification, income tax compliance, relates to capital gains income tax and concealment in bearer bonds of taxable income. Mr. Chapoton testified he had no specific evidence that bearer bonds were used to avoid capital gains tax. Chapoton Tr. 953.

As to the concealment justification, Mr. Chapoton had no specific evidence at the time he testified before Congress that bearer bonds were used for this purpose. Chapoton Tr. 951-952.

The Defendant offered no proof concerning the third justification.

F. Application of Judicial Inquiry to the Record Before the Court

In Garcia, the Court concluded it could review failings in the national political process, or situations in which legislation

completely assumed state authority. The Court said the constitutional structure imposes affirmative limits on federal action affecting the states under the Commerce Clause, citing Coyle v. Oklahoma, 221 U.S. 559 (1911).

Coyle v. Oklahoma involved an attempt by Congress to designate the temporary location of Oklahoma's capital upon its admission to the Union. The Court held:

> the power to locate its own seat of government, and to determine when and how it shall be changed from one place to another, and to appropriate its own public funds for that purpose, are essentially and peculiarly state powers. That one of the original thirteen states could now be shorn of such powers by an act of Congress would not be for a moment entertained.

221 U.S. at 565.

The Court quoted Lane County v. Oregon, 74 U.S. (7 Wall.) 71, 76 (1869), with approval:

> [T]he people of each State compose a State, having its own-government, and endowed with all the functions essential to separate and independent existence.

221 U.S. at 580.

The Government has not argued a constitutional limitation upon the states' authority to borrow money. Rather, it seeks to regulate the valid exercise of the legitimate, necessary governmental activity of raising money through borrowing. It has done so without exhibiting the necessity of the statute. Regulation of an admittedly valid source of funds creates a dependency upon Congressional grace with a concomitant loss of independence. The Special Master found "the statutory sanction is real and exercises a powerful effect upon the states." Report at 148, n. 444. Regulation of a recognized, constitutional source of financing threatens the independence of the states.

G. <u>The Master's Discussion of the Plaintiff's Acquiesce is Irrelevant and Incorrect</u>

South Carolina's Complaint charged that "in the course of the exercise of its sovereign responsibility, South Carolina must borrow money to enable it to function effectively as a provider of services essential to the health and welfare of its citizens." Comp., Paragraph 4, and pursuant to the Constitution of South Carolina it is authorized "to borrow money and to issue general obligation and other bonds." It alleged application of TEFRA's registration requirement to "the general obligations of South Carolina causes irreparable injury to South Carolina and results in the destruction of its sovereignty for which there is no remedy." Id. Paragrah 10.

The Special Master discussed at some length congressional regulations dealing with industrial development bonds and arbitrage

bonds. The question of whether those bond proceeds are immune from federal taxation is not before the Court. Moreover, the Master's discussion of the states' acquiesence in unrelated congressional regulations is inappropriate. The Defendant claims the Plaintiff acquiesed in those regulations and chose not to contest them. Yet from the moment South Carolina asked this Court for relief, the Defendant argued that even this Court was powerless to enjoin the enforcement of the challenged act. Fortunately, this Court did not agree. South Carolina v. Regan, supra.

CONCLUSION

Section 310(b)(1) is constitutionally infirm for two reasons. It asserts congressional controls in a field preserved to the states, thus impermissibly intruding on the sovereignty of the states, and, in blind-side fashion, it unconstitutionally asserts the right of the national government to tax the interest paid by states on their debt obligations despite clear and sound precedent to the contrary.

The contitutional powers of the states must not be carelessly abrogated. The continued existence of the federal system secures the liberties of the citizens of the United States as no other form of government could and far outweighs any remote administrative convenience attaching to the plan here promoted by the United States Congress. That plan must be judicially voided.

RELIEF REQUESTED

The Plaintiff, the State of South Carolina, prays that the Court enter a decree adjudging Section 310(b)(1) of the Tax Equity and Fiscal Responsibility Act of 1982 as applied to the general obligations of South Carolina to be in violation of the Constitution of the United States; and that the Court enter a decree permanently enjoining and restraining the Defendant from enforcing or attempting to enforce Section 310(b)(1) of the Tax Equity and Fiscal Responsibility Act of 1982 against the general obligations of South Carolina; and for such other and further relief as it may deem proper and necessary.

Respectfully submitted,

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May 8, 1987,

Charleston, South Carolina.

Appendix A

STATE OF NEW YORK

EXECUTIVE CHAMBER,

ALBANY

January 5, 1910.

To the Legislature:

I have received from the Secretary of State of the United States a certified copy of a resolution of Congress entitled "Joint Resolution Proposing an Amendment to the Constitution of the United States," and in accordance with his request I submit it to your honorable body for such action as may be had thereon.

The amendment proposed by this joint resolution, adopted by two-thirds of both houses of Congress, is as follows:

> "Article XVI. The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."

The power to lay a tax upon incomes, without apportionment, was long supposed to be possessed by the Federal government and has been repeatedly exercised. Such taxes were laid and paid for the purpose of meeting the exigencies caused by the Civil War.

In 1895, in the case of Pollock v. Farmers' Loan & Trust Company (158 U.S. 601), the United States Supreme Court decided that taxes on the rents or income of real estate, and taxes on personal property or on the income of personal property, are direct taxes and hence under the Constitution cannot be imposed without apportionment among the several States according to their respective populations.

It was not the function of the court, and it did not attempt, to decide whether or not a Federal income tax was desirable. It simply interpreted the Constitution according to the judgment of the majority of its members and left the question of the advisability of conferring such a power upon the Federal government to be determined in the constitutional method.

The limitations so placed upon the Federal taxing power are thus described by Mr. Justice Harlan in his dissenting opinion:

"Any attempt upon the part of Congress to apportion among the States, upon the basis simply of their population, taxation of personal property or of incomes, would tend to arouse such indignation among the freemen of America that it would never be repeated. When, therefore, this court adjudges, as id does not adjudge, that Congress cannot impose a duty or tax upon personal property, or upon income arising either from rents of real estate or from personal property, including invested personal property, bonds, stock and investments of all kinds, except by apportioning the sum to be so raised among the States according to population, it practically decides that, without an amendment of the Constitution -- two-thirds of both Houses of Congress and three-fourths of the States concurring -- such propoerty and incomes can never be made to contribute to the support of the national government. (Id., pp. 671, 2) * * *

"Incomes arising from trades, employments, callings, and professions can be taxed, under the rule of uniformity or equiality, by both the national government and the respective State governments, while incomes from property, bonds, stocks, and investments cannot, under the present decision, be taxed by the national government except under the impracticable rule of apportionment among the States according to population. No sound reason for such a discrimination has been or can be suggested." (Id., p. 680.)

I am in favor of conferring upon the Federal government the power to lay and collect an income tax without apportionment among the States according to population. I believe that this power should be held by the Federal government so as properly to equip it with the means of meeting national exigencies.

But the power to tax income should not be granted in such terms as to subject to Federal taxation the incomes derived from bonds issued by the State itself, or those issued by municipal governments organized under the State's authority. To place the borrowing capacity of the State and of its governmental agencies at the mercy of the Federal taxing power would be an impairment f the essential rights of the State which, as its officers, we are bound to defend.

You are called upon to deal with a specific proposal to amend the Constitution, and your action must necessarily be determined not by a general consideration of the propriety of a just Federal income tax, but whether or not the particular proposal is of such a character as to warrant your assent.

This proposal is that the Federal Government shall have the power to lay and collect taxes on incomes "from whatever source derived."

It is to be borne in mind that this is not a mere statute to be cnstrued in the light of constitutional restrictions, express or implied, but a proposed amendment to the Constitution itself which, if ratified, will be in effect a grant to the Federal government of the power which is defines.

The comprehensive words, "from whatever source derived," if taken in their natural sense, would include not only incomes from

ordinary real or personal property, but also incomes derived from State and municipal securities.

It may be urged that the amendment would be limited by construction. But there can be no satisfactory assurance of this. The words in terms are all-inclusive. An amendment to the Constitution of the United States is the most important of political acts, and there should be no amendment expressed in such terms as to afford the opportunity for Federal action in violation of the fundamental conditions of State authority.

I am not now referrring to the advantage which the State might derive from the exclusive power to tax incomes from property, or to the argument tha tfor this reason the power to tax such incomes should be withheld from the Federal government. To that argument I do not assent.

I am referring to a proposal to authorize a tax which might be laid in fact upon the instrumentalities of State government. In order that a market may be provided for State bonds, and for municipal bonds, and that thus means may be afforded for State and local administration, such securities from time to time are excepted from taxation. In this way lower rates of interest are paid then otherwise would be possible. To permit such securities to be the subject of Federal taxation is to place such limitations upon the borrowing power of the State as to make the performance of the functions of local government a matter of Federal grace.

This has been repeatedly recognized. In the case of The Collector v. Day (11 Wall. on p. 127), decided in 1870, the United States Supreme Court said:

> "It is admitted that there is no express provision in the Constitution that prohibits the general government from taxing the means and instrumentalities of the States, nor is there any prohibiting the States from taxing the means and instrumentalities of that government. In both cases the exemption rests upon necessary implications, and is upheld by the great law of self-preservation; as any government, whose means employed in conducting its operations, if subject to the control of another and distinct government, can exist only at the mercy of that government. Of what avail are these means if another power may tax them at discretion?"

In the case of Pollock v. Farmers' Loan & Trust Co. (157 U.S. on pp. 584-5), Chief Justice Fuller said, referring to the tax upon incomes from municipal bonds, one of the matters there involved:

> "A municipal corporation is the representative of the State and one of the instrumentalities of the State government. It was long ago determined that the property and revenues of municipal corporations are not subjects of Federal taxation. * * *But we think the same want of power to tax the property or revenues of the States or their instrumentalities exists in relation to a tax on the income from their securities."

In the same case Mr. Justice Field said (Id. on p. 601):

> "These bonds and securities are as important to the performance of the duties of the State as like bonds and securities of the United States are important to the performance of their duties, and are as exempt from the taxation of the United States as the former are exempt from the taxation of the States."

And the learned Justice added, quoting from United States v. Railroad Co. (17 Wall. on pp. 322, 327) as follows:

> "The right of the States to administer their own affairs through their legislative, executive, and judicial departments, in their own manner through their own agencies, is conceded by the uniform decisions of this court, and by the practice of the Federal government from its organization. This carries with it an exemption of those agencies and instruments from the taxing power of the Federal government. If they may be taxed lightly, they may be taxed heavily; if justly, oppressively. Their operation may be impeded and may be destroyed, if any interference is permitted. Hence, the beginning of such taxation is not allowed on the one side, is not claimed on the other."

While the justices of the court in the Pollock case differed in opinion upon the question whether a tax upon income from property was a direct tax and as such could not be laid without apportionment, they were unanimous in their conclusion that no Federal tax could be laid upon the income from municipal bonds. Mr. Justice White, who dissented in the Pollock case with regard to other questions, as to this said (157 U.S. on p. 652):

> "The authorities cited in the opinion are decisive of this question. They are relevant to one case and not to the other, because, in the one case, there is full power in the Federal government to tax, the only controversy being whether the tax imposed is direct or indirect; while in the other there is no power whatever in the Federal government, and, therefore, the levy, whether direct or indirect, is beyond the taxing power."

It is certainly significant that the words, "from whatever source derived," have been introduced into the proposed amendment as if it were the intention to make it impossible for the claim to be urged that the income from any property, even though it consist of the bonds of the State or of a municipality organized by it, will be removed from the reach of the taxing power of the Federal government.

The immunity from Federal taxation that the State and its instrumentalities of government now enjoy is derived not from any express provision of the Federal Constitution, but from what has been deemed to be necessary implication. Who can say that any such implication with respect to the proposed tax will survive the adoption of this explicit and comprehensive amendment?

We cannot suppose that Congress will not seek to tax incomes derived from securities issued by the State and its municipalities. It has repeatedly endeavored to lay such taxes and its efforts have been defeated only by implied constitutional restriction which this amdnement threatens to destroy. While we

may desire thaat the Federal government may be equipped with all necessary national powers in order that it may perform its national function, we must be equally solicitous to secure the essential bases of State government.

I therefore deem it my duty, as Governor of the State, to recommend that this proposed amendment should not be ratified.

CHARLES E. HUGHES

5

No. 94, Original

IN THE

Supreme Court of the United States

October Term, 1986

STATE OF SOUTH CAROLINA,
Plaintiff,

NATIONAL GOVERNORS' ASSOCIATION,
Plaintiff-in-Intervention,

v.

JAMES A. BAKER, III, SECRETARY OF THE TREASURY OF THE UNITED STATES OF AMERICA,
Defendant.

EXCEPTIONS OF THE NATIONAL GOVERNORS' ASSOCIATION TO THE REPORT OF THE SPECIAL MASTER AND BRIEF IN SUPPORT THEREOF

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No. 94, Original

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Plaintiff,

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v.

JAMES A. BAKER, III, SECRETARY OF THE TREASURY OF THE UNITED STATES OF AMERICA,

Defendant.

EXCEPTIONS OF THE NATIONAL GOVERNORS' ASSOCIATION TO THE REPORT OF THE SPECIAL MASTER

I. EXCEPTIONS TO THE REPORT OF THE SPECIAL MASTER

On August 16, 1984, the Court appointed the Honorable Samuel J. Roberts, retired Chief Justice for the Supreme Court of Pennsylvania, as its Special Master for the purpose of this action. Following an extensive presentation of evi-

dence, the Special Master reached his conclusions and made recommendations in a Report* submitted on January 22, 1987 and ordered filed on February 23, 1987. The National Governors' Association, which the Special Master recommended that the Court permit to proceed as plaintiff-in-intervention, takes exception to the Special Master's report in the following respects:

EXCEPTION NO. 1

Plaintiff-in-intervention takes exception to the finding of the Special Master that Section 310(b)(1) of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") does not contravene "affirmative limits" upon Congress' regulatory authority found in the Tenth Amendment. These limits are built into the structure of the federal Constitution, which establishes a national government, but recognizes the "separate and independent" existence of the States. The Master reached this conclusion by assuming, erroneously, that the Constitution required examination of the weight rather than the nature of Congress' intrusion on the States' internal government imposed by Section 310(b)(1).

EXCEPTION NO. 2

Plaintiff-in-intervention takes exception to the finding of the Special Master that no interest rate differential exists between registered and bearer bonds. The Master incorrectly concluded that there was no interest penalty on registered bonds by failing to credit a secondary market study by the

* Hereinafter the Special Master's Report will be referred to as "Report"; the Stipulation of Facts entered into by the parties will be referred to as "Stip."; the Trial Transcript will be referred to as "Tr."; the Plaintiffs' Exhibits will be referred to as "PX."

Secretary that revealed this interest rate differential. (Report at 70). In fact, the Secretary's study, as noted by both the plaintiffs and defendant, was meticulously constructed and methodologically sound. Once the errors in data had been corrected, the Secretary's study, which revealed an interest penalty, should have been accepted by the Master.

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v.

JAMES A. BAKER, III, SECRETARY OF THE TREASURY OF THE UNITED STATES OF AMERICA,

Defendant.

BRIEF IN SUPPORT OF EXCEPTIONS TO THE REPORT OF THE SPECIAL MASTER

QUESTION PRESENTED

Whether Section 310(b)(1) of the Tax Equity and Fiscal Responsibility Act ("TEFRA"), which in effect required states and local governments to use their legislative and administrative power to satisfy a federal directive, interfered with the States' separate and independent existence in violation of the principles of federalism expressed by the Tenth Amendment?

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STATEMENT OF JURISDICTION

The original jurisdiction of the Court was invoked by South Carolina under Article III, Section 2, Clause 2 of the Constitution of the United States.

CONSTITUTIONAL PROVISION AND STATUTE INVOLVED

The Tenth Amendment to the Consitution provides: "The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people."

Section 310(b)(1) of TEFRA, 26 U.S.C. §103(j) (1982) provides:

> **(j) Obligations must be in registered form to be tax-exempt.**
>
> **(1) In general**
>
> Nothing in subsection (a) or in any other provision of law shall be construed to provide an exemption from Federal income tax for interest on any registration-required obligation unless the obligation is in registered form.
>
> **(2) Registration-required obligation**
>
> The term "registration-required obligation" means any obligation other than an obligation which -
>
> > (A) is not of a type offered to the public,
> >
> > (B) has a maturity (at issue) of not more than 1 year, or
> >
> > (C) is described in section 163(f)(2)(B) [26 U.S.C. § 163(f)(2)(B)].

(3) Special rules

(A) Book entries permitted

For purposes of paragraph (1), book entry obligation shall be treated as in registered form if the right to the principal of, and stated interest on, such obligation may be transferred only through a book entry consistent with regulations prescribed by the Secretary.

(B) Nominees

The Secretary shall prescribe such regulations as may be necessary to carry out the purpose of paragraph (1) where there is a nominee or chain of nominees.

PRELIMINARY STATEMENT

This is a challenge to the constitutionality of Section 310(b)(1) of TEFRA, which requires the registration of all municipal bonds. Congress enacted Section 310(b)(1) because of concerns that bearer bonds were being used for tax evasion purposes. Plaintiff National Governors' Association ("NGA") challenged Section 310(b)(1) on the grounds that it violated the Tenth Amendment and principles of federalism inherent in the structure of the Constitution.*

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* Plaintiff State of South Carolina challenges Section 310(b)(1) on the ground that the Section's threatened withdrawal of the tax exemption for failure to register violates the doctrine of intergovernmental tax immunity. As discussed, *infra*, the NGA believes the tax immunity issue no longer is presented in this case. Nevertheless, if the Court reaches the issue, the NGA fully supports South Carolina's position that the exemption is constitutionally mandated.

Several points should be noted at the outset. First, the NGA fully supports any Congressional action carefully crafted to address tax evasion. It is in the best interest of the States to see that federal tax evasion is curbed both because the amount of federal revenues frequently determines the monies available for state use and because many states premise their tax collection on federal returns. It is the NGA's position, however, that the manner in which Congress addressed its tax evasion concerns was improper; eschewing more effective methods solely within federal means, Congress employed state governments to address federal concerns.

Second, it is the NGA's position that the Special Master erred in finding Section 310(b)(1) constitutional by mistakenly examining only the weight of the federal intrusion when it is the nature of that intrusion that causes constitutional concern. Section 310(b)(1) had the effect of requiring state and local governments to pass legislation and devote substantial administrative resources to the federal end, diverting those governments from their own agendas. The Master, by and large, accepted the facts as to each of the intrusions offered into evidence by the NGA. But, he upheld the statute, finding that those intrusions imposed a burden the weight of which was "neither trivial nor extraordinary." (Report at 40).

As set out in full below, it is the NGA's position that in assessing the constitutionality of Section 310(b)(1) this Court should focus on the nature of the intrusion into state governmental processes. The question presented in this case is whether it is within Congress' authority to co-opt state governmental processes to reach an end that Congress itself could achieve.

STATEMENT OF THE CASE

On February 7, 1983, South Carolina sought leave to file an original complaint in the United States Supreme Court challenging the constitutionality of Section 310(b)(1). South Carolina contended that the Section violated the Tenth Amendment to the United States Constitution and that the loss of the federal income tax exemption for interest paid on the debt constituted a penalty that violated the doctrine of intergovernmental tax immunity inherent in the federal system.

This Court granted leave to file the original complaint on February 22, 1984. *South Carolina* v. *Regan*, 465 U.S. 367 (1984). The Court believed that South Carolina's complaint raised important federalism issues. Justice Brennan wrote for the Court that "[u]nquestionably, the manner in which a State may exercise its borrowing power is a question that is of vital importance to all 50 States." *Id.* at 382. Concurring, Justice Blackmun observed that the "issue presented is a substantial one, and is of concern to a number of States." *Id.* at 384. In addition to granting South Carolina's motion, the Court appointed a Special Master to develop a factual record.

Subsequent to the appointment of a Special Master, the National Governors' Association ("NGA") filed a motion for leave to intervene as a plaintiff. The NGA is an incorporated instrumentality of the States, the members of which are the chief executives of the fifty States, two Commonwealths and three Territories. Its purpose is to represent the States in the federal system. The NGA premised its motion to intervene on the ground that "[t]he States, Commonwealths and Territories whose chief executives are members of the NGA [would] be bound by the judgment and have a substantial interest in the outcome." *Motion of the National Governors' Association for Leave to Intervene as Plaintiff* at 2. The NGA

stressed to the Master that it would be able to provide the Court with a broad national perspective, drawing upon and demonstrating the impact of Section 310(b)(1) in the fifty states.* The motion was referred by the Court to the Special Master on August 16, 1984.

After briefing and oral argument, the Special Master recommended that the motion for leave to intervene be granted. This recommendation was premised upon the NGA satisfying certain conditions imposed to prevent duplication of proof at the hearing. Subsequently, the Special Master found that the NGA "met those conditions." Moreover, the Master found that "NGA's contribution to the fact-finding process has been substantial and has materially aided the Special Master in discharging his duties." (Report at 4 n.7).

The parties engaged in substantial discovery. Following discovery, three weeks of hearings were held before the Special Master. At those hearings, the plaintiffs introduced evidence as to the nature and extent of the federal intrusion into state and local government imposed by Section 310(b)(1) of TEFRA. The defendant, in turn, introduced evidence to show that despite these intrusions, there were certain benefits to registration ("market benefits") and that registration was justified by Congress' concern that bearer instruments were being used to avoid federal taxes ("tax benefits").

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* The NGA was supported in its motion by the Academy for State and Local Government, the Council of State Governments, the International City Management Association, the National Association of Counties, the National Conference of State Legislatures, the National League of Cities and the United States Conference of Mayors.

The parties submitted proposed findings of fact and briefs on the merits in support of those findings. On the basis of the submissions, the Special Master found that Section 310(b)(1) did not impose burdens on the States the weight of which were sufficient to render the statute unconstitutional. The Master did not, however, address the question whether the very nature of the federal intrusion on state processes required by this statute made it unconstitutional.

STATEMENT OF FACTS

The municipal bond market is numerous and diverse, consisting of some 47,000 issuers of municipal bonds ranging in size from large states and public agencies to small towns and school districts. (Report at 20). Although the largest of issuers may issue several billion dollars worth of debt per year, seventy-six percent of issuers issue less than 10 million dollars per year. (*Id.* at 20-21).

Municipal bonds provide a critical source of funds used by state and local governments to meet the pressing needs of their citizens. Proceeds from municipal bonds most often are used to finance capital improvements for essential government functions. For example, in 1984 approximately $27 billion raised from general obligation bonds was spent building and maintaining roads, bridges, jails, schools and municipal buildings. Funds from municipal revenue bonds totalling $74 billion in 1984 were used for numerous functions such as water and sewage, hospitals, public power, pollution abatement, public housing, mortgage subsidies and student loans. (Stip., Para. 19).

Considerable state time, energy and money is devoted by state and local governments to the approval and issuance of municipal debt. The "importance of debt issuance to the

States is reflected in the detail in which state constitutions, statutes and ordinances prescribe the procedures by which debt may be incurred and issued." (Report at 77). The procedures and provisions vary widely from state to state and from issuer to issuer. States have, since the founding of the Union, valued their prerogative to shape the raising of revenue. All regulatory schemes generally mandate that the process remain under strict control of the citizens and their elected representatives. State constitutions generally require statewide referenda before issuance of debt obligations that are secured by the borrowers' full faith and credit. (Stip., Para. 19).

Until 1983 the 47,000 issuers of municipal bonds had one thing in common: their debt was issued almost exclusively in bearer form. (Report at 23). Bonds held in bearer form are negotiable instruments that are easily transferred. (*Id.* at 24). Congress, in requiring registration, was concerned that this ready negotiability led to tax evasion. *See infra* at 17. The record in this case shows, and the Master found, however, that the vast majority of bearer bonds are negotiated through brokers. (*Id.* at 85). These brokers have a legal obligation to report the transfers to the Internal Revenue Service ("IRS"). As a result, the tax evasion problem caused by the illicit negotiation of bearer bonds is significantly reduced. (*Id.* at 82).

Pursuant to Section 310(b)(1), as of July 1, 1983, all 47,000 issuers were required to stop issuing their debt in bearer form and switch to a system of issuing registered bonds. Section 310(b)(1) requires that municipal bonds be registered in order to maintain their tax-exempt status. (*Id.* at 1). Because forfeiture of tax-exempt status would increase the rate of interest state and local governments pay on their obligations by 28% to 35%, Section 310(b)(1) effectively

requires the registration of these municipal obligations. (*Id.* at 2).

Under a registration system, the issuer or its "transfer agent" maintains a registry of the record owners of registered bonds. (*Id.* at 24). Although beneficial ownership is a matter for negotiation, legal title can only be transferred by recording the change in the agent's books. Transfer of record ownership of registered certificated bonds occurs when the seller surrenders the old certificates to the issuer or to a transfer agent, who then updates the ownership records, cancels the old certificate, and issues a new certificate to the buyer. (*Id.* at 25). Requiring that the bonds be registered lessens their negotiability.

Even the fact-findings of the Special Master call into question the extent to which registration assisted tax authorities in addressing tax evasion. Of critical importance, the transfer agents required by registration to record transfers do not report bond transfers to the IRS, while brokers always did so. (*Id.* at 82). Moreover, registration is unhelpful for information reporting to the IRS. Its only benefit in preventing tax evasion is in providing a "paper trail" to be followed by IRS agents investigating tax fraud. Even this paper trail is of limited value, however, because the record owner on the books of the transfer agent need not be the real owner, who can remain anonymous by an arrangement that is not reflected on the transfer agent's books. (*Id.* at 26-27). Effective methods of preventing tax evasion are as important to the States as to the federal government. Unfortunately this statute does not provide such a method.

PLAINTIFF'S CASE: THE INTRUSIONS ON STATE AND LOCAL GOVERNMENT CAUSED BY REGISTRATION

The NGA offered evidence at trial through the testimony of state and local officials that the registration requirement impermissibly intruded on the States' sovereign functions in five ways. Except for the interest rate differential, the Special Master made findings consistent with the plaintiff's position as to each of these intrusions.

1. Legislative Costs

The NGA asserted, and the Special Master found, that Section 310(b)(1) required the States to pass numerous laws to comply with, and implement, the federal standard. Prior to the effective date of TEFRA, many state laws required that bonds be issued in bearer form or forbade their issuance in any other form. *Report of the Conference on Registered Municipal Securities* at 9 (Washington, D.C. October 18, 1982). Other state laws — such as those requiring authentic signatures on bonds — could not be adapted to a registration system and had to be amended. (Report at 38). In order to comply with TEFRA, these state laws and regulations, direct and indirect, had to be swept away. The Special Master observed that the "time and money expended to comply with TEFRA, both at the legislative and administrative levels, was not insignificant." (*Id.* at 36).

The NGA presented extensive evidence as to the legislative costs imposed on four representative states. (*Id.* at 36). The Special Master noted these examples. There is no dispute that this evidence is representative of the experience of the fifty states.

In New Jersey,* for example, forty-seven separate statutes had to be amended in order to comply with TEFRA. (*Id.* at 36). The coordination of the drafting and passage of the bills was tremendous, requiring the services of a lawyer in the Governor's office. (*Id.* at 37). The executive branch solicited advice as to the substance of the bills from investment professionals who developed drafts. (*Id.* at 37). A statewide committee became involved to ensure a smooth transition for local governments and authorities. (*Id.*). After several months of meetings, draft legislation was circulated to the many different interested parties. At the same time the executive branch had to work with the legislature to convince other legislators to withdraw legislation they had introduced, on the ground that parallel legislation would confuse rather than distill the necessary requirements. (*Id.* at 34). In Kansas,** eighty-six statutes had to be amended and three repealed; and in Michigan*** and Illinois,**** a similar diversion of state resources was required to comply with the registration requirement. (*Id.* at 38).

This experience, typical of the States, forced state officials to turn the time and resources of their state

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* Michael Horn, who at the time of trial was the State Treasurer of New Jersey, testified on plaintiffs' behalf. (Tr. 202-92).

** Robert Knight, a councilman and former Mayor of Witchita, Kansas, also supported NGA's case at trial. (Tr. 527-52).

*** Robert Bowman, the State Treasurer of Michigan, observed that considerable confusion was caused in the state legislature by the demands of TEFRA. (Tr. 674-754).

**** Governor Thompson testified for the plaintiffs, noting the obstacles that Illinois had to overcome to comply with TEFRA. (Tr. 355-97).

governments from other functions and priorities in order to meet the federal requirement.

2. Administrative Transition Costs

Effecting the transition to registration also imposed significant administrative burdens upon the States and their municipalities. Issuers who had not developed any expertise in issuing or marketing registered bonds now had only nine months to implement a working system. (Report at 38). Because Section 310(b)(1) mandated registration for all issuers, with no exceptions or provisions tailored to the size of the issuer or the problems the issuer might encounter, state and local governments had to organize numerous meetings and education sessions to ensure compliance. (*Id.* at 39). Responsible officials at the state and local level conferred, attended seminars and met with local bankers to develop administrative proposals to effect the transaction. (*Id.* at 39). In New Jersey, for example, several high-level members of the Treasurer's staff devoted substantial time to effecting registration, choosing transfer agents, re-evaluating bid procedures and accomplishing related tasks. (*Id.* at 39). In addition, the state had to hire eleven temporary employees and expend hundreds of hours of overtime to accomplish the myriad tasks associated with the transition. (*Id.* at 39).

Fifteen members of Michigan's Treasury staff spent as many as ten days away from routine duties. (Tr. 724). The experience was similar in New Jersey, Illinois and Kansas. (*Id.* at 40). Responsible officials were thus diverted from pressing state and local government business to attend to the transition to registration. As the Special Master observed the "record leaves no doubt that TEFRA required numerous changes in existing state administrative procedures . . . [T]hese changes consumed personnel time and required the

expenditure of computer and financial resources." (*Id.* at 40).

3. Transaction Costs

In order to determine the transaction costs associated with the issuance of registered bonds, both parties engaged the Government Finance Research Center to conduct a joint study of registration transaction costs. (Report at 40). The study found that the ongoing administration costs — such as the fees paid by issuers for the payment of interest coupons, and retirement of principal — were higher for registered than bearer bonds for the smaller issues, that is, under $10 million. (*Id.* at 41). Seventy-six percent of municipal bond issues are of $10 million or less. (Stip., Para. 13). In addition, certain fixed costs, such as the high minimum annual fee charged by transfer agents, had a greater financial impact on those smaller issuers. (Report at 43).

4. Interest Rate Differential

The interest rate differential — a higher rate of interest demanded by purchasers of registered bonds — proved to be the most difficult cost for either plaintiffs or defendant to assess.* In its original complaint South Carolina asserted that issuance in registered form would impose a substantial interest penalty. (Brief of Plaintiff at 22). Although the

* Because the bond market may fluctuate as much as 10-20 basis points daily, it is very difficult to isolate a differential of 5-15 basis points between points in bearer and registered form. (PX 200 at 4). In order to determine, without an econometric model, that a differential existed, a bond trader would have to see two bonds that were identical in every way, except for their form, bearer or registered, trade at the exact same time. This will never occur often enough to assess the differential accurately.

penalty asserted would be enormous in real dollars, the differential — a matter of several basis points — was small enough relative to bond market fluctuations to be very difficult to measure. The Secretary devoted substantial resources to developing a primary market model that would accurately determine the differential. (*Id.* at 45). But the study had fundamental flaws and the Special Master concluded that it was unreliable. (*Id.* at 76-77).

There were three ways to go about measuring the differential: rely on testimony of market witnesses, try to measure the differential in the primary (original issuance) bond market, or try to measure the differential in the secondary (trading of already-issued bonds) market. Plaintiffs eschewed the first two methods as unreliable. (*Id.* at 56). The first method was unreliable because a differential of several basis points simply could not be unobserved in a fast-moving market even by an experienced observer — instead, an econometric study was required. (PX 200). And, it is unnecessary to dwell at length on the difficulty with a primary market study — the Master was convinced it was wholly unreliable. A primary market study requires a comparison of matched pairs of registered and bearer bonds in the primary market after TEFRA. But because there were no bearer municipal bonds issued after TEFRA, it was difficult "to develop surrogates for a direct comparison." (*Id.* at 55). The Master found that this was "a fundamental methodological difficulty with the Secretary's primary market study." (*Id.* at 75).

Both the plaintiffs and defendant presented secondary market studies performed by economists and statisticians in the field to try to show that the enactment of TEFRA had an effect on the interest rates of municipal bonds. The plaintiffs' study indicated a 5-15 basis point differential, but the Master found the study unreliable. (*Id.* at 62, 76). Initially, the Secretary's study did not show a differential; but in the course

of the trial testimony, plaintiffs' experts demonstrated that a crucial data error in the Secretary's secondary market study had skewed the sample away from showing a differential.* Once the error had been corrected, the Secretary's secondary market study produced results that supported the claim of the plaintiffs that an interest rate differential does in fact exist. (*Id.* at 70; Tr. 1663-65). Although plaintiffs found the data error, they did not — nor could they — fault the comprehensiveness or methodology of the Secretary's model. It was exhaustive and expensive. But once plaintiffs located the error with the result of changing the conclusions, the Secretary sought to abandon his study. (Report at 70).

The Secretary's representatives, on numerous occasions, had expressed confidence in the thoroughness of the study even though their expectation of its results proved wrong after the data error was rectified: "[I]t is a very comprehensive study, and [it] will conclude that unequivocally there is no indication that . . . there's a penalty. . . . Registration does not create an interest penalty for the issuers." (Opening Statement by Donald J. Gavin, Trial Counsel for the Secretary, Tr. 105-106). During his deposition, defendant's expert, Donald Puglisi, when asked about the reliability of the data,

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* The Secretary's secondary market study compared sets of matched registered and bearer bonds in that market to measure the differential. But the Secretary's study erroneously included one large matched set in which a registered bond with bond insurance was paired with a bearer bond without bond insurance. (Tr. 1660-62). Obviously an insured bond sells at a premium to an uninsured one, so the erroneous inclusion of this set skewed the study results. When the set was removed, the Secretary's study showed an eight basis point differential, with a very high degree of statistical significance.

stated that he was "as sure as [he] can be" that it was reliable and that he had used the "best sources available." (Puglisi deposition at 38).

Contrary to the finding of the Special Master, the Secretary did not abandon his study because it was unreliable and its conclusions untenable, but simply because it no longer supported his claims. (Report at 70). Plaintiffs maintain the Master's finding is in error and that plaintiffs proved that the Secretary's study substantiated plaintiffs' claim that a 5-15 basis point differential existed, which would result in an annual cost to state and local governments of $100 million per basis point for each year TEFRA was in force. (PX 200).

5. The Diminution of Sovereignty

The sovereign power to impose taxes and to make decisions is central to the separate and independent existence guaranteed to the several states by the Constitution. Raising funds in public markets has been, for more than a century, a fundamental part of the exercise of that power that lies at the heart of a state's autonomy. In addition to noting the four intrusions, described above, plaintiffs argued that the commandeering of state legislative processes diminished their sovereignty. *See Coyle* v. *Smith*, 221 U.S. 559 (1911). The essence of state sovereignty is the power of the States to make basic organizational and operational decisions without federal directives. Requiring debt to be issued in registered form has limited the decision-making function of the state and local governments because it dictates to the governments charged with the authority to issue debt and the responsibility to repay it the policy decision of the form and means of issuance of that debt. Thus, compliance with Section 310(b)(1) diverts state governments from other critical issues, diminishing their separate and independent existence.

THE SECRETARY'S CASE: MARKET AND TAX BENEFITS

With the exception of the interest rate differential, the Secretary accepted plaintiffs' evidence as to the intrusions set out above, disputing only their weight and constitutional significance. In order to mitigate the weight of the intrusions established by plaintiffs, the Secretary premised his entire case upon proving the benefits of registration to the bond market and the national fisc.

1. Market Benefits

The Secretary sought to prove that issuers would benefit from market efficiencies inherent in the registration process. (Report at 79). Plaintiffs consistently maintained this evidence was irrelevant, both because Congress had not justified the statute on these terms, and because there was no evidence that such efficiencies inured to the benefit of issuers. The Special Master agreed, finding that "although in a perfect market one would expect that market efficiencies would redound to the benefit of issuers, there is no direct evidence of this in the record." (*Id.* at 80). In response to the Secretary's one assertion of a direct benefit — that underwriting spreads had been reduced in response to registration — the Master explicitly found "it seems unlikely that registration would account for the major part of these issuer savings." (*Id.*). In fact, there is no evidence that registration accounted for the issuers' savings. The Secretary evidently does not challenge this finding. (Letter from Charles Fried, Solicitor General of the United States to Joseph Spaniol, Jr., Clerk of the Supreme Court (January 28, 1987) (notifying the Court that the Secretary would not except to any of the Master's findings)).

2. Tax Benefits

The objectives Congress sought to accomplish by its enactment of Section 310(b)(1) were set out in the Senate Report. First, Congress sought to establish a "fair and efficient system of information reporting and withholding . . . [of] interest bearing obligations." The Committee felt that registration would produce useful information while preserving the liquidity of the obligations. Second, Congress believed that registration would hamper the ability of recalcitrant taxpayers to avoid income, estate and gift taxes by the use of bearer bonds. Finally, Congress expressed a belief that registration of bonds would reduce the volume of convenient cash substitutes available for use in illegal activities. S. Rep. No. 494, 97th Cong., 2d Sess., 242 (1982).

These three goals, as set out by the Committee in its report, were adapted virtually without change from the testimony of Assistant Secretary for Tax Policy, John Chapoton before the Senate Finance Committee. (Tr. 935-38). Mr. Chapoton admitted at trial that neither he nor his staff at the Department of Treasury had conducted any studies or analyses that would support his testimony. Despite this lack of analytic support, Congress enacted Section 310(b)(1) based on the benefits recited by Mr. Chapoton. At trial, the NGA vigorously contested whether the statute addresses the problems that Congress perceived. The Special Master has admitted that the arguments presented by plaintiffs "do have some force." (Report at 85). The NGA fully supports Congress' objective to discourage tax evasion but continues to question whether the Section contributes to that crucial effort.

In reverse order, Congress' third rationale — illegal money laundering — was abandoned by the Secretary at the

outset of the litigation. In response to discovery requests for information that municipal bearer bonds were used to launder funds, the Secretary chose not to defend the statute on this ground. (Letter from Glenn L. Archer, Jr., Assistant Attorney General, Tax Division to Barry Friedman (October 25, 1985) (noting that the "extent and nature of money laundering is not an issue in this case")). The Special Master also found no evidence to suggest that bearer bonds may have been used as a cash substitute for illegal activities. (Report at 84).

Chapoton's main rationale, which was echoed in the Senate Report, concerns the ability of noncompliant taxpayers to avoid taxation by use of bearer bonds. There are three kinds of taxes which Congress could have had in mind: federal income tax, capital gains tax and estate and gift tax. Because interest on municipal bonds is not taxable under federal law, the interest income tax evasion argument has no force. With regard to concealment of other kinds of taxes, the Special Master correctly found that there is no evidence "quantifying the estate and gift tax evasion [or] capital gains tax evasion." (*Id.* at 84).

Even assuming the evasion Congress suspected, registration is of little enforcement value. The primary means of addressing alleged bearer bond abuse was increased information reporting. This was Congress' first goal. With regard to the information reporting goal, however, even the Special Master conceded that there are "imperfections in the regulatory scheme [of Section 310(b)(1)]." (*Id.* at 88). As a result, the Special Master rightly concluded that "there are limitations to the utility of the registration requirement as an aid to

tax enforcement." (*Id.* at 88). Brokers are required to file information regarding the transfer of bonds and were required to do so even prior to the passage of TEFRA. But registered bonds, like bearer bonds, can be transferred without a broker. (Tr. 939-940). In other words, persons trading bonds can still evade reporting requirements. Moreover, it does not help to add a transfer agent to the system, as registration does, for transfer agents have no reporting obligations to the IRS.*

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* The Special Master erred in finding that "IRS and treasury officials have the authority under existing statutes to require information reporting by transfer agents when and if it is deemed necessary." (Report at 83). Although brokers report trades of both bearer and registered bonds to the Internal Revenue Service, there is no legislative authority to require transfer agents charged with transferring registered bonds to report transfers.

Section 6045(a) of the Internal Revenue Code provides that only a person "doing business as a broker" must, when required by regulations, make an information return in accordance with regulations. Therefore, the Internal Revenue Service may not require such information reporting by persons other than brokers. The term "broker" is defined in Section 6045(c) of the Code as a "dealer, barter exchange or any other person who (for a consideration) regularly acts as a middleman with respect to property or services." Section 1.6049-4(f)(4) of the regulations defines "middleman" as any person who "acts in a capacity as intermediary between a payor and a payee." A transfer agent who merely records the names of the beneficial owners of the bonds therefore does not act as middleman with respect to bond sale payments.

Logic indicates that Congress could not have intended to confer on the Internal Revenue Service power to require the filing of returns setting forth the proceeds of sales when those filing would have no knowledge of such proceeds. A transfer agent merely records the fact of a record transfer, but has no actual knowledge or reason to have knowledge of the nature of the transaction that caused the transfer, *i.e.*, whether it was a sale involving gross proceeds or whether it was a gift or transfer at death. Further, even if a transfer agent had reason to believe that a transfer involved a sale, the transfer agent would have no knowledge as to the gross proceeds of the sale. Accordingly, transfer agents would be unable

(See PX 120, attached).

As the Master found, the only real value to registration is that there is somewhat more of a "paper trail" in place for use by IRS agents tracing tax fraud. But this paper trail is of very limited utility. First, it requires locating specific bonds that the IRS suspects were used for evasion. But even when bearer bonds actually were found by IRS agents, they generally could determine who possessed them. Second, because registered bonds can be held in nominee name, even the registration paper trail may not ultimately lead IRS agents to the bonds' owner.

The Special Master agreed with the plaintiffs that the registration requirement imposed certain burdens on the states. He also noted the fragility of the benefits to which the Secretary pointed. Because the Master examined the weight not the nature of the intrusions imposed by Section 310(1)(b), he found that those intrusions were not enough to justify striking the Section in light of the tax benefits asserted by the Secretary and Congress' intent in passing the statute. It is to the crucial constitutional test of the nature of the impositions created by this statute that we now turn.

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to comply with any information reporting requirements that the Internal Revenue Service might seek to impose upon them. There is, therefore, no basis for the Internal Revenue Service to believe that it has the power to extend its regulations in such a manner.

SUMMARY OF ARGUMENT

Section 310(b)(1) effectively requires the states and local governments to use their legislative and administrative power to satisfy a federal directive; by so doing this statute interferes with the States' separate and independent existence in violation of the principles of federalism expressed by the Tenth Amendment. Those principles impose certain limits on the reach of Congress' power to regulate the states. Although the contours of those limits have not been free from doubt for this Court, it has never been questioned that their foundation may be found in the very structure of the Constitution which establishes a national government but contemplates the continued and autonomous existence of the States.

Most recently in *Garcia v. San Antonio Transit Auth.*, 469 U.S. 528 (1985), this Court observed that while the national political process offers the states their first defense against improper federal intrusion, there are also "affirmative limits" on Congress' power to regulate them. These limits are described by the precedent that the *Garcia* Court both cited, *Coyle v. Smith*, 221 U.S. 559 (1911) and left untouched, *FERC v. Mississippi*, 456 U.S. 742 (1982). In *Coyle*, cited by the *Garcia* Court in support of its notion of affirmative limits, this Court struck down a federal statute that dictated to a state where it should place its state capital. In *FERC*, while this Court upheld a statute that asked states to consider the implementation of federal regulations, it observed that the statute was valid only because the state deliberative processes were not co-opted by the federal command.

The line that *Coyle* and *FERC* drew separated those actions that Congress may constitutionally require the States to take from those it may not. Although the evil warned

against in *FERC* was the actual commandeering of state processes, *Coyle* made clear that the symbolic occupation by the federal government of the statehouse was also invalid.

When the *Garcia* Court proffered to the States the recourse of the national political process as their defense against illegitimate federal intrusion, it contemplated the continued and vigorous ability of the States to assert their — or rather their citizens' — needs. By picking up the baton passed by *FERC* and *Coyle*, the *Garcia* Court implied that the States' ability to function in the federal system as separate and independent — to operate for the benefit of their citizens in the political process — would be threatened as much by a symbolic as an actual kidnapping of state government by Congress.

Section 310(b)(1) poses just such a threat because by its very nature it requires the states to subordinate their own agendas to that of the federal government. While Congress may achieve its ends by direct action — as it could have easily done in this case — it may not reach its goal by using state machinery when to do so would crucially divert the States' attention from the needs of their citizens. This is because our federal system presumes that its citizens have the right to the attention of both its sovereigns and, in particular, the attention of the state government to their needs. This is not to say that in times of dire national emergency the federal government may not, for a brief time, press all the nation's resources, including that of the state, to its service. This, however, is not such a case. Rather the demands made here by the federal government transgress those affirmative limits so carefully plotted by *Coyle*, *FERC* and *Garcia*.

ARGUMENT

I.

SECTION 310(b)(1) IS NOT A TAX, BUT IS A REGULATION OF THE STATES THAT REQUIRES THEM TO REGISTER MUNICIPAL OBLIGATIONS

The constitutional question properly presented by this case is whether Section 310(b)(1) of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") is consistent with the principles of federalism expressed in the Tenth Amendment.* This legislation is constitutionally suspect because it in effect required the States to pass laws and devote substantial administrative resources solely to satisfy a federal directive, a role inconsistent with their separate and independent existence in the federal system.

At the outset, plaintiffs advanced two arguments challenging the constitutionality of Section 310(b)(1). First, plaintiffs argued that requiring the States to issue debt in registered form, with its attendant usurpation of state political processes, violated principles of federalism expressed by the Tenth Amendment. In addition, plaintiffs contended that under the intergovernmental tax immunity doctrine, Congress was without constitutional authority to eliminate the tax

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* In this brief we use "Tenth Amendment" and "principles of federalism" interchangeably because the Tenth Amendment is an expression of the principles of federalism implicit throughout the Constitution. The Tenth Amendment "expressly declares the constitutional policy that Congress may not exercise power in a fashion that impairs the States' integrity or their ability to function effectively in a federal system." *Fry* v. *United States*, 421 U.S. 542, 547 n.7 (1975).

exemption on municipal debt. This Court appointed a Master to develop and find facts on both issues.

It is now clear, in the aftermath of extensive fact-finding proceedings, that it is not necessary for this Court to address the intergovernmental tax immunity issue. That is because Section 310(b)(1) is not a tax, but is a regulation in aid of Congress' taxing power. *See, e.g., M'Culloch* v. *Maryland*, 17 U.S. (4 Wheat.) 316 (1819). If any municipal authority had issued bonds in bearer form subsequent to the effective date of Section 310(b)(1) the tax exemption on those bonds would be lost and a tax immunity issue would be presented. But the Master found that, as expected, Section 310(b)(1) effectively mandated state and local governments to register their bonds. After the effective date no state failed to comply and none incurred the tax penalty. Thus, Section 310(b)(1) must be examined, and reversed or upheld, as what it in fact is: not a tax but a regulation in aid of Congress' taxing power.*

Facts found before the Master amply support the conclusion that Section 310(b)(1) is a regulation, not a tax. The Master determined that he need not decide the question of whether Congress could eliminate the tax exemption, because Congress had not done so. Rather, Congress clearly anticipated that all government entities would register rather than forfeit the exemption. At the outset of the litigation, the

* Congress expressed no intention to pass this law in order to increase revenue, and no revenue has been raised as a result of its passage. Without either the intent or effect of raising revenue this Section lacks the single most important indicia of a tax. *See United States* v. *Kahriger*. 345 U.S. 22, 28 (1953); *see also, South Carolina* v. *Regan*, 465 U.S. 367, 384 (1984) (Blackmun, J., concurring) ("evident" that purpose of Section 310(b)(1) was not "to produce revenue").

parties stipulated to the fact that the tax penalty associated with registration was so great that all state and municipal governments would register. (Stip., Para. 6). And the Master found that all have done so: the Master concluded, at the very beginning of his report, that Section 310(b)(1) "in effect *requires* the registration of all municipal bonds." (Report at 2) (emphasis supplied).*

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* The Special Master's report was somewhat inconsistent in its application of this finding. In response to the Tenth Amendment argument, the Master determined that the statute was constitutional, in part because Congress did not require States to use governmental machinery to a federal end, but offered the States the choice of registering to retain the tax exemption or not registering and forfeiting the exemption. In response to the tax immunity argument, the Master determined that he need not decide whether Congress could eliminate the exemption because Congress had not done so, clearly anticipating that all government entities would register rather than forfeit the exemption. However, the statute either required registration or it provided a choice: both cannot be true.

In light of the actual operation of the statute, under which every State did switch to registered bonds — a result that the Congress anticipated and the parties stipulated to — it is evident that this inconsistency can only be resolved by recognizing that the section did *require* the States to register their obligations. The Master found that to be a fact. (Report at 2).

II.

THE PRINCIPLES OF FEDERALISM PROHIBIT CONGRESS FROM COMMANDEERING STATE LEGISLATIVE PROCESSES TO ACCOMPLISH A FEDERAL REGULATORY END THAT IS WITHIN CONGRESS' MEANS TO ACCOMPLISH

A. The Constitutional Scheme Limits Congress' Power To Regulate The States

Plaintiffs maintain that the regulatory impact of Section 310(b)(1) is invalid not because it is beyond the scope of Congress' delegated powers, but because it transgresses limits that may be found in the very structure of the constitutional scheme, a structure which established a national government, but which also contemplates the continued, separate and independent existence of the States. The structure of the Constitution presupposes the independent existence of state governments. The Tenth Amendment makes this much clear, providing that the "powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people." U.S. Const. amend. X. In glossing that amendment, this Court has observed that the "Amendment expressly declares the constitutional policy that Congress may not exercise power in a fashion that impairs the States' integrity or their ability to function effectively in a federal system." *Fry* v. *United States*, 421 U.S. 542, 547 n.7 (1975).

Congressional legislation that treats the States inconsistently with their independent status is not invalid because it crosses some explicit line, but because it is contrary to the assumption underlying the Framers' vision of the Constitution as a whole. *Texas* v. *White*, 74 U.S. (7 Wall.) 700, 725 (1869) ("the preservation of the States, and the maintenance

of their governments, are as much within the design and care of the Constitution as the preservation of the Union and the maintenance of the National Government"). Congress has broad power to raise taxes for the general welfare and generally may enact any regulation necessary and proper to effectuate that power. In this case, however, the object of congressional regulation is the legislative, administrative and political processes of state government. Accordingly, that regulation must be tested against the principles of constitutional federalism.

Determining exactly what kind of legislation treats States in a manner that is inconsistent with the federal scheme has been an inquiry not free from trouble for this Court. *See EEOC* v. *Wyoming*, 460 U.S. 226 (1983); *United Transportation Union* v. *Long Island Railroad Co.*, 455 U.S. 678 (1982); *Hodel* v. *Virginia Surface Mining & Reclamation Ass'n*, 452 U.S. 264 (1981); *National League of Cities* v. *Usery*, 426 U.S. 833 (1976). Most recently in *Garcia* v. *San Antonio Metropolitan Auth.*, 469 U.S. 528 (1985), this Court suggested a new approach to defining the limits of congressional authority to regulate the states.

In *Garcia*, this Court re-evaluated the framework it had established ten years before for determining the constitutionality of direct federal regulation of the states. Under the rule established by that earlier decision, *National League of Cities* v. *Usery*, 426 U.S. 833 (1976) "areas of traditional governmental functions" were considered immune from federal regulation. *Id.* at 852. Over time it became clear that the test could not be applied with any consistency of result because of the difficulty in distinguishing a traditional governmental function from a nontraditional one.

Recognizing the futility of attempting to carve out specific areas of state authority that would be held relatively free from federal regulation, the *Garcia* court chose to

abandon this approach, and relied instead on the "principal means chosen by the Framers to ensure the role of the states in our federal system," that is, "the structure of the Federal Government itself." *Garcia*, 469 U.S. at 550. Instead of totting up governmental functions as pluses or minuses in some ultimate constitutional ledger, this Court determined to rely upon the self-regulating role of politics to keep our dual system of sovereignty faithful to the Framers' conception of federalism; in this scheme it is the political process, rather than the Supreme Court, that provides the primary protection of the States' autonomy.

Despite its primary reliance on the political process, the *Garcia* Court did not hold, and could not have held consistent with 200 years of constitutional history, that Congress was without bounds in regulating the States. Rather, the *Garcia* majority explicitly recognized the "special and specific position" of the States in our federal union, and acknowledged that there were "affirmative limits" upon Congress' power to depose the States from their special position. *Garcia*, 469 U.S. at 556. For the principle that "affirmative limits" exist the Court cited *Coyle* v. *Smith*, 221 U.S. 559 (1911). *Coyle*, in turn, had affirmed that "the Constitution, in all of its provisions looks to an indestructible Union, composed of indestructible States," *id.* at 579 (quoting *Texas* v. *White*, 74 U.S. (7 Wall.) 700, 725 (1869)) "having its own government, and endowed with all the functions essential to separate and independent existence." *Id.* at 580 (quoting *Lane County* v. *Oregon*, 74 U.S. (7 Wall.) 71, 76 (1869). And, it is this concept that the Court itself looked to in *Fry* v. *United States*, 421 U.S. 542 (1975) in an opinion joined by four Justices of the *Garcia* majority then on the Court when it stated that the

Tenth Amendment

> expressly declares the constitutional policy that Congress may not exercise power in a fashion that impairs the States' integrity or their ability to function effectively in a federal system.

Id. at 547 n. 7.

Moreover, *Garcia* did not suggest that the Court would turn a deaf ear to claims by the States that congressional legislation seriously impaired their "ability to function effectively" in the federal system, *Fry*, 421 U.S. at 547 n.7, abdicating all responsibility for regulating Congressional incursions into areas of state power. Although the Secretary has taken that position in this litigation, to follow him would be to overrule *sub silentio* this Court's oldest and soundest precedent. Time and time again this Court has asserted and jealously guarded its role as the final arbiter of what the Constitution requires and as the final umpire of disputed areas of authority between the states and the national government. *See, e.g., Marbury* v. *Madison*, 5 U.S. (1 Cranch) 137 (1803); *M'Culloch* v. *Maryland*, 17 U.S. (4 Wheat.) 316 (1819); *Fry*, 421 U.S. 542; *Maryland* v. *Wirtz*, 392 U.S. 183 (1968).* *Garcia* is not inconsistent with these core principles: the

* *See generally*, Van Alstyne, *The Second Death of Federalism*, 83 Mich. L. Rev. 1709 (1985) (discussing historical support for Supreme Court's role as arbiter and noting that the country never would have ratified a constitution that explicitly excluded the Supreme Court and left to the national Congress the resolution of questions concerning State sovereignty). It is consistent with this "important duty" of the Supreme Court that the Court's original jurisdiction specifically applies to suits by the States against the national government. *See South Carolina* v. *Regan*, 465 U.S. 367, 384 (O'Connor, J., concurring) (original jurisdiction provides States acceptable alternative to diplomacy and war for settling disputes).

Garcia Court stated only that in the factual setting of *National League of Cities* and *Garcia* the political process had performed as intended, and therefore "[t]hese cases do not require us to identify or define what affirmative limits the constitutional structure might impose on federal action affecting the States." *Garcia*, 469 U.S. at 556.

B. Congress May Not Commandeer State Legislative And Administrative Processes, For This Threatens The Separate And Independent Existence of the States

The *Garcia* Court made it clear that although the Court expects the national political process generally to protect state autonomy, there are affirmative limits upon Congress' power to regulate the States directly. While this Court did not explicitly describe those limits, the framework it offered and the one hundred years of precedent it left untouched indicate that this Court will scrutinize carefully the intrusiveness of Congressional regulation of the States to insure that the regulation does not threaten the States' separate and independent existence.

As developed below, it is plaintiffs' position that Congressional legislation threatens the separate and independent existence of the states when it co-opts state governmental machinery to federal ends, diverting state governments from their own pressing agendas. *See FERC* v. *Mississippi*, 456 U.S. 742 (1982); *Coyle* v. *Smith*, 221 U.S. 559 (1911); *See infra* at 30-38. Section 310(b)(1) had the effect of usurping state political and deliberative processes, requiring the states to pass laws and devote significant administrative resources to implementing the federal plan. Plaintiffs maintain it is precisely this kind of federal interference in the autonomous workings of state government — the co-option of state government machinery to federal ends — that threatens the "separate and independent existence" of the states,

hampering their ability to function in the national political process, and transgressing the "affirmative limits" acknowledged by the *Garcia* Court. That is not to say that in a case of national emergency Congress could not request temporary assistance from state governments. *See FERC*, 456 U.S. at 745. *See infra* at 42-44. But in this case Congress had adequate means in its own governmental arsenal to combat the tax evasion problems it perceived.

In order to understand the malady of the federal intrusion in this case, it is necessary to return to the fundamental constitutional point that whatever "rights" a state has derive from its role as protector of and proxy for the individual rights of its citizens. The Tenth Amendment, after all, states that all powers not expressly delegated to the federal government are "reserved to the States respectively, or to the people." U.S. Const. amend. X. And in *Coyle* v. *Smith*, 221 U.S. 559 (1911) — the *Garcia* Court's citation for the "affirmative limits" proposition — the Court also made clear that the sovereignty of the citizenry was of paramount concern, stating "*[t]he people of each state* compose a state having its own government, and endowed with all the functions essential to separate and independent existence." *Id.* at 580 (quoting *Lane County* v. *Oregon*, 74 U.S. (7 Wall) 71, 76 (1869)) (emphasis added).

By ratifying the Constitution, the people created a federal government, but they also sought to guarantee the separate and independent existence of the States, free to pursue independent state agendas. *The Federalist* No. 39 at 260 (Madison) (E. Bourne, ed. 1937); *Erie R.R. Co.* v. *Tompkins*, 304 U.S. 64, 78-79 (1938); *Texas* v. *White*, 74 U.S. (7 Wall.) 700, 725 (1869). Under the constitutional plan envisioned by the Framers, and ratified by the people of the States, the federal government possesses certain delegated powers, while everything not delegated is reserved to the States. U.S. Const. amend. X. Under that plan citizens have an

expectation and indeed a right to a state government unhampered by federal demands and free to respond to the citizens' needs. It is the importance of having the attention of both sovereigns, if focused in different ways, that is the special mark of American federalism. Action on the part of the Congress that removes state political processes from direct control of state citizens, diverting state government to federal ends, accordingly is invalid under *Garcia*.

The two hundred years since the ratification of the Constitution have seen an expansive interpretation of the powers delegated to the national government. *Wickard* v. *Filburn*, 317 U.S. 111 (1942). This expansion has been an appropriate response to an equally expansive concept of the fifty states as one nation. Advances in technology, communication and transportation all have served to draw together the people of the fifty states, presenting problems of uniquely national scope that require national solution. Despite this expansion of federal authority, however, federal legislation, enacted in response to pressing national needs, or at the behest of special interest groups, tends to be "generally interstitial in its nature." Hart and Wechsler, *The Federal Courts and the Federal System*, 470 (2d ed. 1973).

> Federal legislation, on the whole, has been conceived and drafted on an *ad hoc* basis to accomplish limited objectives. It builds upon legal relationships established by the states, altering or supplanting them only so far as necessary for the special purpose. Congress acts, in short, against the background of the total *corpus juris* of the states in much the way that a state legislature acts against the background of the common law, assumed to govern unless changed by legislation.

Id at 470-71.

Thus, the people of the States continue to look to state government to fulfill basic and changing needs. State government is the ultimate provider of fundamental needs and services. *See, e.g.*, Michelman, *States' Rights and States' Roles: Permutations of "Sovereignty" in National League of Cities* v. *Usery*, 86 Yale L.J. 1165 (1977); Tribe, *Unravelling National League of Cities: The New Federalism and Affirmative Rights to Essential Government Services*, 90 Harv. L. Rev. 1065 (1977); Kaden, *Politics, Money, and State Sovereignty: The Judicial Role*, 79 Colum. L. Rev. 847 (1979). When the people's needs are basic — education, police, transportation — it is to state government that the people look first. When a state "speaks" in a national forum it speaks for its citizens and expresses their concerns. Citizens look to the States as their primary provider, as the first level of government; the States must be able to respond to and shape those demands if they are to establish their sovereignty. States provide the first, and sometimes the only, response to "the changing needs of their citizenry." *Garcia*, 469 U.S. at 546; *see also* Governor Thompson's testimony (Tr. 387) (states "have been on the cutting edge of government reform and on the cutting edge of the utility of government in making a better life for our people").

In order to meet these needs, state governments must be able to develop and further their own agendas free from federal intrusion. Agenda-setting, the determination how to allocate scarce legislative and administrative resources lies at the heart of what it means to be a separate and independent unit of government. The "affirmative limits" acknowledged in *Garcia* are violated when congressional legislation diverts state government from state agendas. When the federal government moves into a new area, it may preempt state efforts and deal with the problem in a national manner. *Pacific Gas & Elec. Co.* v. *State Energy Resources Conservation and Dev. Comm'n*, 461 U.S. 190 (1983); *Hines* v.

Davidowitz, 312 U.S. 52 (1941). But, the federal government must pursue its agenda without impeding state efforts to deal with the multitude of problems that they, like the federal government, face. The *Garcia* majority recognized precisely this point, stating:

> The essence of our federal system is that within the realm of authority left open to them under the Constitution, the States must be equally free to engage in any activity that their citizens choose for the common weal, no matter how unorthodox or unnecessary anyone else — including the judiciary — deems state involvement to be.

Garcia, 469 U.S. at 546; *see also Helvering* v. *Gerhardt*, 304 U.S. 405, 427 (1938) (Black, J., concurring) ("the genius of our government provides that, within the sphere of constitutional action, the people — acting not through the courts but through their elected legislative representatives — have the power to determine as conditions demand, what services and functions the public welfare requires").

The invalidity of the federal intrusion in this case rests on the fact that Section 310(b)(1) unnecessarily co-opts state legislative and political processes to a federal end. It commandeers the state's political processes and puts it to the task of addressing, in a specific and short time-frame, the agenda determined by the federal government. When the federal government chooses to address a new regulatory program and then compels state governments to implement that program, the states not only lose control over a matter formerly within state purview, but also must abandon other vital state concerns to carry out the federal command. The former is the price of our federal system; the latter is forbidden, for it deprives the citizens of the several states of a separate and independent government addressed to separate and independent problems. *See Texas* v. *White*, 74 U.S. (7 Wall.) 700,

725 (1869); *Lane County* v. *Oregon*, 74 U.S. (7 Wall.) 71 (1869); *Coyle* v. *Smith*, 221 U.S. 559 (1911); *Fry* v. *United States*, 421 U.S. 542 (1975). Any other interpretation of "separate and independent" reduces the state governments to administrative units in the federal hierarchy.

FERC v. *Mississippi*, 456 U.S. 742 (1982) indicates that federal co-option of state governmental processes violates the affirmative limits referred to in *Garcia*. Although the *Garcia* court addressed, and explicitly rejected, the mode of analysis of *National League of Cities* and its progeny, the *Garcia* Court did not discuss *FERC*, recognizing (as did the *FERC* Court) that the intrusiveness of federal regulation at issue in *FERC* was different in kind from that in the *National League of Cities* cases:

> This case obviously is related to *National League of Cities* v. *Usery*, 426 U.S. 833 (1976), insofar as both concern principles of state sovereignty. But there is a significant difference as well. *National League of Cities*, like *Fry* v. *United States*, 421 U.S. 542 (1975), presented a problem the Court often confronts: the extent to which state sovereignty shields the States from generally applicable federal regulations. In PURPA [the statute at issue in FERC], *in contrast, the Federal Government attempts to use state regulatory machinery to advance federal goals. To an extent, this presents an issue of first impression.*

FERC, 456 U.S. at 758-59 (emphasis supplied).

FERC involved a challenge to Titles I and III of the Public Utility Regulatory Policies Act of 1978 ("PURPA") that directed state utility regulatory commissions and nonregulated utilities to "consider" the adoption and implementation of specific "rate design" and regulatory standards; it also required state commissions to follow certain notice and comment procedures when acting on proposed federal standards.

Id. at 746, 748.

The *FERC* Court observed that differences between *FERC* and the *National League of Cities* cases presented a "troublesome" question: although the federal government has "some power" to enlist state processes to federal ends, it had to be careful that the power not be used to displace state government. *Id.* at 761. The Court never had "sanctioned explicitly a federal command to the States to promulgate and enforce laws and regulations," *id.* at 762, precisely because it is "having the power to make decisions and to set policy [that] gives the State its sovereign nature." *Id.* at 761.

It is the *FERC* decision, therefore, that forges the link between the *Garcia* Court's insistence that affirmative limits exist and the unquestioned constitutional command that states retain their separate and independent existence. The separate and independent existence of the States means that states must be free to pursue the regulatory agenda of their citizenry. And, it is in a state's deliberative body that the people speak directly to the government to express their needs. It is a state's administrative processes that carry out the will of the people expressed in state legislation. In the state political arenas — legislative and administrative — the States form and carry out the agenda that will make them effective advocates for their own existence, that is, their role as their citizens' providers.

Depriving the States of the ability to control their own deliberative processes limits their effectiveness in the national political process. This explains the *Garcia* Court's reliance on *Coyle* for the "affirmative limits" proposition. The *Garcia* Court indicated that it is this federal interference in state deliberative processes that threatens the separate and independent existence of the States. In *Coyle*, the Court struck down a federal statute that changed the location of a state capital. It cannot be seriously contended that loss of the

power to determine the seat of government would, in one fell swoop, obliterate states as we know them. Whether the Oklahoma state legislature passes its laws in Tulsa rather than Oklahoma City would not affect their content.

What this Court recognized in *Coyle* was that although the placement of the state capital may have little impact on the day-to-day functioning of state government, it would have a very real effect on a state's citizens' perception of the autonomy — and therefore efficacy — of its state government. The state's effectiveness relies upon the support and belief of its citizens. This support is undermined when the citizens believe that the state does not even have the ability to choose its own seat of government. A state bereft of the autonomy to make such internal decisions is unlikely to have any serious credibility in the national political process.*

Garcia's affirmative limit, therefore, is that Congress may not unnecessarily co-opt state political, deliberative and administrative processes to federal ends. If Congress perceives a national need, Congress may address it, even if it means depriving state government of authority over a formerly "traditional" state area. *See*, *e.g.*, *National League of Cities* v. *Usery*, 426 U.S. 833 (1976). But, Congress must address the concern on its own, leaving the state governments free to pursue the remaining needs of their citizenry. *See Garcia*, 469 U.S. at 546.

* Indeed, the central concern in *Coyle* was that the federal government treat every state with equal dignity. It was only when the states stood on this equal footing as to their sovereign functions and attributes, that they could fulfill their role as "indestructible" states without which the Union could not exist. Just as equal dignity is essential, one state to another, equal dignity is important between the States and the federal government if the States are to retain a vital voice in the national political process.

C. Section 310(b)(1) Co-opts State Legislative Machinery And Therefore Is Unconstitutional

Measured by the *FERC* decision and the principles underlying it, Section 310(b)(1) must fall because the federal intrusion is precisely of the type that threatens the separate and independent existence of the States. Section 310(b)(1) effectively mandates the States to abandon other priorities, to enact laws and to divert other significant financial and administrative resources simply to accomplish federal ends well within the independent power of the federal Congress to achieve. *See infra* at 42. The fact that Section 310(b)(1) effectively requires state legislation is particularly suspect for the Supreme Court "never has sanctioned explicitly a federal command to the States to promulgate and enforce laws." *FERC*, 456 U.S. at 761-62.

More than in *FERC* or *Coyle*, the co-option of state democratic processes by Section 310(b)(1) transgresses the affirmative limits on Congress' power to regulate the States. For more than half of the states, compliance with TEFRA demanded either a change in state laws or a very imaginative interpretation of the state laws. *Report of the Conference on Registered Municipal Securities* at 9. Enormous expenditures of administrative resources were required. See *infra* at . A full plate of state and local issues was reorganized to make room for federal priorities.

In order to comply with TEFRA, the States had to repeal old laws and pass new ones. The Special Master observed that "the time and money expended to comply with TEFRA, both at the legislative and administrative levels, was not insignificant." (Report at 36). The commandeering of state legislative processes is evident in the proof that NGA presented at trial. In New Jersey, for example, forty-seven different statutes had to be amended in order to comply with TEFRA. In Kansas, eighty-six statutes had to be amended

and three repealed; and in Michigan, a similar diversion of state resources was required to comply with the registration requirement. (Report at 38). This experience, typical of the States, forced state officials to turn the time and resources of the state from other functions and priorities of state government, including pressing executive and legislative business.

These are precisely the burdens Congress may not impose consistent with the Tenth Amendment. This diversion of state attention away from its sovereign processes is the line that *FERC* made clear the federal government could not cross. By co-opting state processes to federal ends, Congress deprives the States of the very weapon that *Garcia* proffered in order for them to maintain their role in the federal system.

In *FERC*, this Court ultimately approved the statute because it merely asked state administrative bodies to "consider" the federal proposals, but did not require the promulgation of particular regulations.* The mere consideration of federal proposals was deemed acceptable as part of a program of cooperative federalism. Quoting *Hodel* v. *Virginia Surface Mining & Reclamation Ass'n*, 452 U.S. 264, 289 (1981), the Court stated that:

> [t]he most that can be said is that the . . . Act establishes a program of cooperative federalism that allows the States, within limits established by federal minimum standards, to enact and administer their own regulatory programs, structured to meet their own particular needs.

FERC v. *Mississippi*, 456 U.S. at 767.

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* Other provisions of PURPA were sustained because they did nothing more than require that state adjudicatory processes be available on a nondiscriminatory basis. *See Testa* v. *Katt*, 330 U.S. 386 (1947).

The effect of Section 310(b)(1) stands in sharp contrast to the effect of PURPA examined in *FERC*. Section 310(b)(1) did not invite states to consider federal standards, but commanded compliance. Nor was there a hint of the co-operative federalism applauded in *FERC*. Congress, in passing PURPA, recognized that the States would be unlikely to want to forego energy regulation altogether, and so the statutory scheme envisioned a sharing of responsibility. If any state did not want to co-operate, it could abandon the field without sanction. Section 310(b)(1), on the other hand, mandated state action to meet a federal goal, with no shared responsibility, and imposed a sanction so harsh that states had no choice but to comply.

The Special Master recognized these intrusions into state processes. Nonetheless he suggested that Section 310(b)(1) could withstand constitutional challenge on several counts. First, after evaluating the intrusiveness of Section 310(b)(1) the Master found no reason for constitutional concern in this case because the burdens were "neither trivial nor extraordinary." (Report at 40). Second, the Master argued that because Congress could pre-empt the field entirely, it could regulate the states in the less intrusive method proposed by Section 310(b)(1). Quoting the Solicitor General's comparison of this case with *Garcia*, the Master stated:

> If Congress may directly regulate the wage and salary expenses incurred by the States in providing key government services . . . Congress may surely impose the far less significant compliance cost incurred by the states in issuing their bonds in registered form.

(Report at 123).

Both arguments fail and for the same reason: the Special Master failed to recognize that the nature of the federal intrusion in this case — the mandated co-option of state

governmental machinery — distinguishes this case from those that have preceded it.

When the Special Master found that the federal intrusion was neither "trivial nor extraordinary" he was referring to how much trouble it was to pass the laws in question and to implement them. But the Master misunderstood the constitutional significance of the intrusion by confusing its weight with its nature. It is not the ease *vel non* with which a state legislature may pass laws that is the measure of the federal intrusiveness, but whether the Constitution permits the federal government to command the States to pass any law at all.

The Master also missed the point in suggesting that because Congress could have directly regulated the interstate movement of bonds under the commerce clause,* the States have no cause for complaint when it took the less intrusive route provided by Section 310(b)(1). (Report at 128). The argument is flawed because Congress simply may not further a federal end by compelling the exercise of a state's sovereign powers.**

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* Reference to the commerce clause is unnecessary, as Congress could have accomplished the same result here with a regulation in aid of its taxing authority. Indeed, that is what NGA argues Congress should have done. *See infra* at 42.

** In advancing this argument the Master apparently relied on language in *FERC* that suggested Congress could, rather than pre-empting an area entirely, use a "lesser intrusion" of shared regulation. This concept of "cooperative federalism", whatever its application in *FERC*, is (as explained above) wholly inapposite here. In *FERC*, the intrusion was "lesser" because states were given an option of foregoing regulation entirely or of sharing responsibility. Here there was no option and no sharing. The States were told to meet the federal end and were forced to divert their own agenda to do so.

If Congress perceives a need for federal regulation it must, whenever possible, pursue that regulatory end using federal, and not state and local, means. In this case, for example, Congress could have addressed its tax evasion concerns in ways that did not require the commandeering of state legislative and administrative bodies. Congress could have forbidden the transfer of bearer bonds without the services of a broker. And, if Congress felt recordation of bonds was necessary, it could have enacted a federal mandate that all bearer municipal securities be immobilized in a securities depository. Both of these would have been more effective than registration, and neither would have intruded upon or diverted the states' governmental machinery.

D. In An Emergency, State Processes May Be Available For Federal Use

All of this is not to say that when other solutions are unavailable, Congress may not utilize state and local regulatory means: in the face of a national emergency, a temporary request for assistance from the states might be appropriate. For example, in *FERC* v. *Mississippi*, 456 U.S. 742, 745 (1981), discussed, *supra* at 35-40, the Court upheld Congressional legislation that was "designed to combat the nationwide energy crisis" and noted that Congress believed the legislation was "essential to the success of any effort to lessen the country's dependence on foreign oil, to avoid a repetition of the shortage of natural gas that had been experienced in 1977, and to control consumer costs." *Id.* at 746. And in *Fry* v. *United States*, 421 U.S. at 548, this Court upheld Congressional action freezing state wages on the grounds that the statute was an emergency measure essential "to counter severe inflation that threatened the national economy." *See also Case* v. *Bowles*, 327 U.S. 92, 101 (1946) (Court found that in time of war Congress could control the price of state timber sales to combat inflation).

The regulation of state government by Section 310(b)(6) was unjustified because even assuming tax evasion concerns

proffered by Congress, there were more than adequate means of meeting the problem without state involvement. As indicated earlier, (to choose one approach) Congress could have passed legislation requiring that bonds be transferred by brokers to retain negotiability. This would have been *more* effective than Section 310(b)(1), for all broker sales are reported to the Internal Revenue Service while no registered bond transfers through transfer agents are reported. With adequate national means at hand, state government cannot be co-opted.

This, then, is the foundation for our disagreement with the Special Master that the burdens imposed by Section 310(b)(1) were not constitutionally significant. The Master found the intrusion not unconstitutional because the weight of the intrusion was not "extraordinary;" but he did not examine the crucial issue whether the nature of the registration requirement invaded the States' separate and independent existence. Absent national emergency, the Constitution does not require extraordinary assumption of state and local government processes before this Court can address that intrusion.* Rather, the Constitution forbids Congressional regulation of a kind that commandeers state deliberative and administrative processes. When Congress imposes on the States in this way it deprives them of the ability to protect

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* This Court may step in before Congress literally legislates away the separate status of the state governments:

> [N]o one expects Congress to obliterate the states, at least in one fell swoop. If there is any danger, it lies in the tyranny of small decisions — in the prospect that Congress will nibble away at state sovereignty, bit by bit, until someday essentially nothing is left but a gutted shell.

L. Tribe, *American Constitutional Law* § 5-20 at 302 (1978).

themselves in the national political process. The intrusion represented by Section 310(b)(1) transgresses exactly those affirmative limits placed upon the national government by the constitutional plan.

CONCLUSION

For the foregoing reasons, the NGA requests that this Court find Section 310(b)(1) an unconstitutional exercise of Congress' power.

Respectfully submitted,

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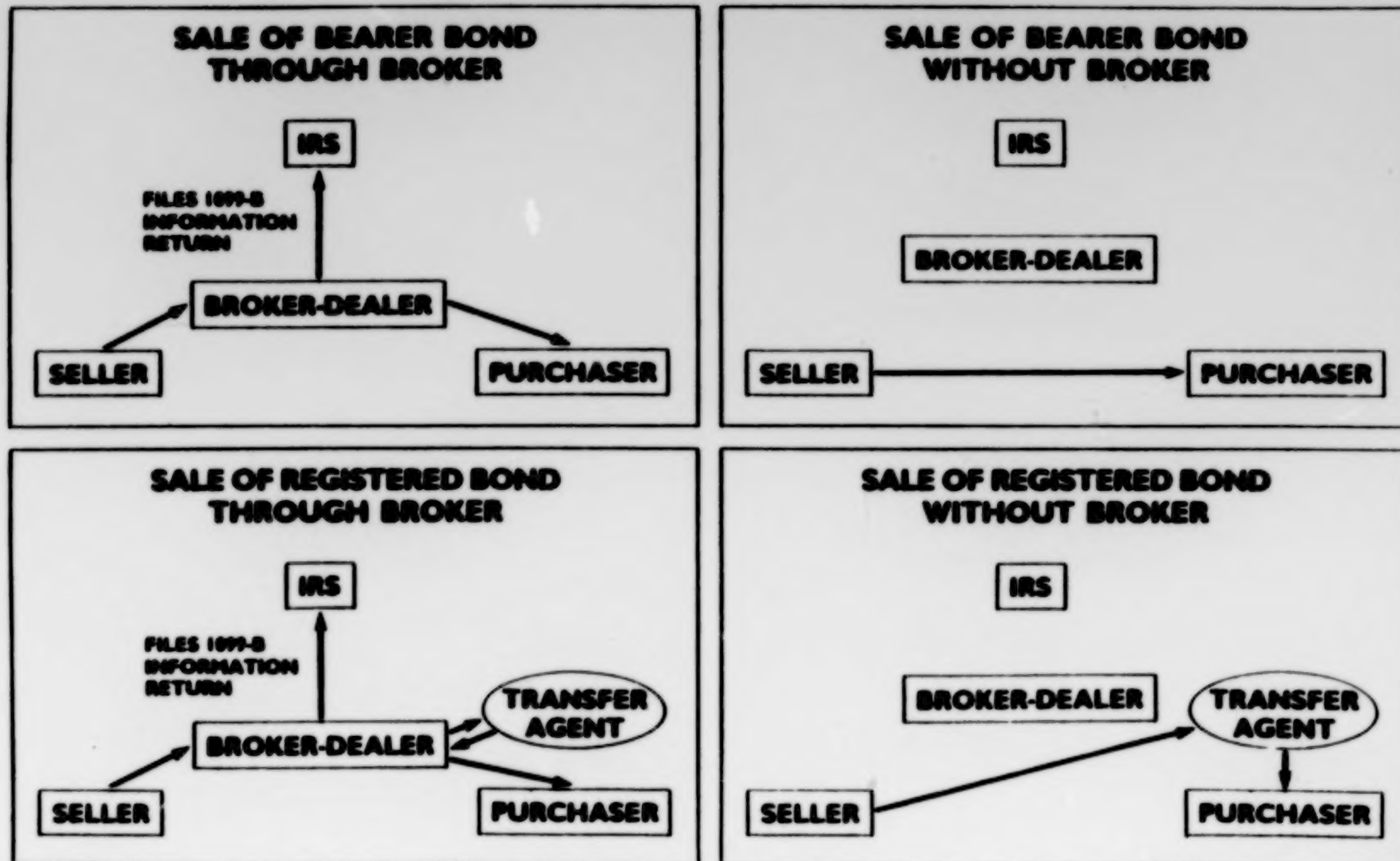
INFORMATION REPORTING



PLAINTIFF'S EXHIBIT 120

(6)

No. 94, Original

IN THE
SUPREME COURT OF THE UNITED STATES
OCTOBER TERM, 1984

STATE OF SOUTH CAROLINA,
Plaintiff

NATIONAL GOVERNORS' ASSOCIATION,
Plaintiff In Intervention,

v.

JAMES A. BAKER, III,
SECRETARY OF THE TREASURY OF THE
UNITED STATES OF AMERICA,
Defendant

BRIEF OF THE AMICUS CURIAE STATES OF PENNSYLVANIA, ALASKA, ARIZONA, FLORIDA, HAWAII, INDIANA, IOWA, LOUISIANA, MARYLAND, MISSISSIPPI, MISSOURI, MONTANA, NEW HAMPSHIRE, NEW JERSEY, NORTH CAROLINA, NORTH DAKOTA, OHIO, OKLAHOMA, VERMONT, VIRGINIA, WEST VIRGINIA, WISCONSIN, AND WYOMING IN SUPPORT OF PLAINTIFF

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INTEREST OF AMICI CURIAE

The interest of the *amici* states in this case is the imperative need to administer their own fiscal affairs free of interference from the national government. As sovereign entities within the federal system, the states have historically had the right, and the responsibility, to provide essential public services, to raise the revenues necessary to fund them, and to decide how these revenues will be raised. In order to continue to do this in an effective and efficient manner, the states must retain the ability to raise funds through, among other means, debt instruments which are competitive in the marketplace and which are not unreasonably burdensome or costly to administer.

"The power to make decisions and set policy is what gives the state its sovereign nature." FERC v. Mississippi, 456 U.S. 742, 761 (1982). This sovereignty is inherent in the federal system of government established by the Constitution.

Section 310(b)(1) of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), now codified as §103(j) of the Internal Revenue Code, directly impairs this sovereignty. The requirement that municipal bonds must be registered or have their interest taxed is not merely an abstract encroachment on state sovereignty. This legislation has the very real, practical effect of eliminating one of the options historically available to states for raising revenue.

Simply put, the inability of the states to issue tax-exempt bearer instruments increases the cost, and hence the difficulty, of securing revenue and providing public services. The legislation thus impairs the ability of the states to make decisions and set policy.

Amici states submit that this legislation is an unconstitutional exercise of Congress' taxing power in that it impermissibly infringes on state sovereignty, while at the same time creating no substantial benefit for the federal government. _Amici_ have a clear stake in the outcome of this case, and respectfully urge this Court to find §310(b)(1) of TEFRA unconstitutional.

SUMMARY OF ARGUMENT

The doctrine of intergovernmental tax immunity is inherently linked to the notion of individual states as sovereign components of the federal system. Perhaps the most essential right of a sovereign state is the right to raise funds to finance its activities through such taxation and borrowing programs as it finds appropriate. While states are generally subject to nondiscriminatory taxes on various transactions in which they might engage, it clearly remains the law at this time that the core functions of states as states are beyond the reach of federal taxation.

This Court continues to recognize the reservation to the states of those powers not delegated to the federal government or otherwise prohibited to

the states. The extension of federal taxation to the borrowing powers of the states as attempted in TEFRA clearly intrudes on those reserved powers and justifies the intervention of this Court to declare such an attempt unconstitutional.

ARGUMENT

I. SECTION 310(b)(1) OF TEFRA IS AN UNCONSTITUTIONAL INFRINGEMENT ON STATE SOVEREIGNTY AS MANIFESTED IN THIS COURT'S DECISIONS ON INTERGOVERNMENTAL TAX IMMUNITY.

The legislation at issue in this case is §310(b)(1) of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Pub.L. 97-48, 96 Stat. 596, codified as §103(j) of the Internal Revenue Code, 26 U.S.C. §103(j) (1982 ed.). It requires that municipal bonds,[1] in order to retain their former exemption from federal income

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[1]The Special Master has discussed the details and mechanics of the municipal borrowing process and markets in Part IV of his Report (at 19-33). It is sufficient for present purposes to note that municipal bonds are debt instruments issued by states or their political subdivisions, the great majority of which constitute "registration required obligations" as described in TEFRA §310(b)(1).

taxation of their interest, must be in registered form if issued after June 30, 1983, the effective date of TEFRA.

Before this date, almost all municipal bonds were issued in bearer form. Bearer bonds are negotiated by transfer and are presumed to be owned by those who hold them. Holders of bearer bonds detach coupons which are presented for the payment of interest. The ownership of registered bonds, on the other hand, is recorded on one or more lists and interest payments are made by check or electronic transfer. Because bond investors demand a higher yield on a taxable debt obligation, TEFRA's mandated loss of tax exemption for bearer instruments is such that no state or local government has issued bearer bonds since the enactment of TEFRA.

This court has long held the traditional view that municipal bonds are immune from federal taxation. Pollock v. Farmers Loan & Trust Co., 157 U.S. 429 (1895). Such immunity is rooted not in legislative grace, but rather grows from the very soil of state sovereignty under the Constitution. In considering whether income from municipal bonds could be subjected to a federal corporate net income tax, this Court held that such an application of the tax in question would cause it to fall directly upon the power of a state to borrow money, an incident the federal government lacked the constitutional authority to tax, and was thus constitutionally impermissible. Pollock at 586.

There is no disagreement with the Special Master's characterization of <u>Pollock</u> as a case which imposes an absolute prohibition on the federal taxation of municipal bond interest, without regard to the magnitude of the burdens such taxation might impose on the states. Masters Report, at 160. Nor is it argued that later cases have not taken a more flexible view of this immunity and limited its application in certain circumstances. It is clearly <u>not</u> the case, however, that there has been any substantial limitation of a constitutionally based intergovernmental immunity from taxation of certain activities and prerogatives which are at the very core of state sovereignty, such as the ability to fund its own operations through taxation and borrowing.

This link between the tax immunity of the states and state sovereignty survived the passage of the Sixteenth Amendment in 1913. In Metcalf & Eddy v. Mitchell, 269 U.S. 514 (1926), the Court, citing Pollock and Weston v. City Council of Charleston, 27 U.S. (2 Pet.) 449 (1829), reiterated the link between intergovernmental tax immunity and sovereignty:

> This Court has repeatedly held that those agencies through which either government immediately and directly exercises its sovereign powers, are immune from the taxing power of the other. Thus, its obligations sold to raise public funds, its investments of public funds in the securities of private corporations, for public purposes surety bonds exacted by it in the exercise of its police power are all so intimately connected with the necessary functions of government, as to fall within the established exemption; and when the instrumentality is of that character, the immunity extends not only to the instrumentality itself but to income derived from it.

269 U.S. at 521 (citations omitted).

While the scope of state income tax immunity has diminished in the years since Metcalf, the immunity itself, and its central concept, survive.

The Special Master has concluded that Metcalf & Eddy and its progeny (Helvering v. Mountain Producers Corp., 303 U.S. 376 (1938); Helvering v. Gerhardt, 304 U.S. 405 (1938); Graves v. New York ex. rel. O'Keefe, 306 U.S. 466 (1939)) stand for the proposition that a federal tax could be imposed upon income derived from dealings with states unless there was a showing that such a tax would impair the states in their central functions. There is a common thread in these and other cases discussed by the Special Master in his Report (at 164-174), and it is on this basis that these cases are distinguishable from the case presently before the Court. None

of the cases discussed in the Report involve the basic fiscal and revenue powers of the state. Rather, these cases all involve the state as an economic competitor in the arena of commerce: as a contractor, James v. Dravo Contracting Co., 302 U.S. 134 (1937); as a lessor, Mountain Producers Corp., 303 U.S. 376 (1938); or as an employer, Gerhardt, 304 U.S. 405 (1938); and Graves, 306 U.S. 466 (1939)). There is no question that a state may be subjected to a nondiscriminatory tax which treats all such commercial actors equally. New York v. United States, 326 U.S. 572 (1946). Even the cases which involve municipal bonds can be distinguished; in both cases, the bonds themselves were merely transferred between private parties. Willcuts v. Bunn, 282 U.S. 216 (1931) involved a tax

on the capital gain when bonds are sold, and Greener v. Lewellyn, 258 U.S. 384 (1922) involved an inheritance tax upon the transfer of bonds at the holders death. The state was not a party to the transaction subjected to tax in either instance.

This distinction is brought into clear focus in Massachusetts v. United States, 435 U.S. 444 (1977), in which this Court found a federal excise tax upon aircraft constitutionally valid when applied to state aircraft. In this case, the state was acting not as a state, but as the owner and operator of aircraft, and was held liable for payment of a non-discriminatory[2]

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[2]This Court has consistently recognized the constitutional validity of various flat taxes and user fees.

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user fee for the provision of airport facilities. Even in so holding, however, the Court continued to recognize the conceptual link between state sovereignty and intergovernmental tax immunity, stating that "the existence of the states implies some restriction on the national taxing power," 435 U.S. at 454. Neither Massachusetts nor any of the earlier cases relied on by the Special Master

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(FOOTNOTE CONTINUED)

Capitol Greyhound Lines v. Brice, 339 U.S. 542 (1950). Massachusetts v. United States represents the extension of this type of tax to the states when they enjoy, on the same basis as private users, the use of the facilities funded by the tax. While Massachusetts involved a federal "user fee" imposed on all civil aircraft, including those used by the states for law enforcement, in order to recoup costs for federal aviation programs, the Court did not find the distinction between a tax and a user fee significant for purposes of analyzing immunity, at 435 U.S. 460, n.18.

sanctions a tax which falls directly on the core activities of states as states. Thus, while any number of state functions are subject to taxation,[3] the central concept of the traditional view -- the link between sovereignty and immunity -- is preserved in the Court's continued recognition that "the limitation [on state sovereignty] cannot be so varied or extended as seriously to impair . . . the appropriate exercise of the functions of the government affected

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[3] See, e.g., New York v. United States, 326 U.S. 572 (1946) (tax on water bottled and sold by State upheld); Helvering v. Gerhardt, 304 U.S. 405 (1938) (federal tax on salaries of state employees upheld); Allen v. Regents, 304 U.S. 439 (1938) (Tax on admissions to state athletic events upheld even though funds were used to support essential state functions); Helvering v. Powers, 293 U.S. 214 (1934) (tax on operations of railroad by State); Ohio v. Helvering, 292 U.S. 360 (1934) (tax on state liquor operation).

by it." Massachusetts v. United States (quoting New York v. United States), 435 U.S. at 459.

Massachusetts analyzes the limitation on Congress' taxing power in terms of a balancing of the benefits and burdens created by the legislation. This analysis takes as its premise not the presumed rationality of the legislation, but rather the irreducible sovereignty of the states which federal taxing legislation may not diminish.

Given that premise -- a premise founded on the role of the states in the federal system -- federal tax legislation which impairs this sovereignty is an improper exercise of Congress' taxing power. This is the case with TEFRA.

While the traditional view of state immunity from taxation has been modified over time, the essential link between tax immunity and state sovereignty is still recognized by this Court. The cases holding that municipal debt is not taxable retain their vitality under the test set out in Massachusetts v. United States. The soundness of the traditional view is reinforced by the practical impact of TEFRA, which, by effectively depriving the states and municipalities of a principal means of raising tax-exempt revenue, represents an extension of the taxing power of the federal government which unduly interferes with the exercise of the states' functions. Massachusetts, at 466-467. Therefore, Section 310(b)(1) of TEFRA is an unconstitutional infringement on state sovereignty as exemplified in the states' tax immunity.

II. SECTION 310(b)(1) OF TEFRA IS AN UNCONSTITUTIONAL INFRINGEMENT OF STATE SOVEREIGNTY PROTECTED BY THE TENTH AMENDMENT TO THE UNITED STATES CONSTITUTION.

The Tenth Amendment to the United States Constitution provides:

> The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people.

This Court has struggled in recent years to formulate a test or a method of analysis under which the judicial process can rationally and consistently discern the limits of state sovereignty under this provision. This Court has recently changed its view of this problem, turning away from a search for traditional governmental functions to look instead for those "postulates which limit and control" federal intrusion upon the retained sovereignty of the

states. Garcia v. San Antonio Metropolitan Transit Authority, 469 U.S. 528, 547 (1985) Garcia expressly overruled National Leagues of Cities v. Usery, 426 U.S. 833 (1976), which relied on the distinction between traditional and non-traditional governmental functions in holding that Congress could not, under its Commerce Clause power, enforce the minimum wage and overtime provisions of the Fair Labor Standards Act against the states.

In thus changing its viewpoint, however, this Court has not abandoned its recognition of the sovereign rights of the states, which they retain ". . . to the extent that the Constitution has not divested them of their original powers and transferred those powers to the Federal Government." Garcia, 469 U.S. 549.

Thus, the structure of the federal system itself plainly contemplates sovereign states with powers reserved to them. However difficult it may be to state an organizing principle in light of which those reserved powers can be clearly discerned, one proposition should be a beacon: sovereignty is meaningless in the absence of the right of a state to raise funds through such taxation and borrowing as it deems appropriate.

While the applicability of the Garcia decision to this case can be effectively questioned on the narrow ground that it expressly limits itself to Commerce Clause enactments,[4] there

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[4]Unlike the legislation challenged in Garcia, TEFRA 301(b)(1), affects only states and municipalities. The Fair

(FOOTNOTE CONTINUED ON NEXT PAGE)

is a broader argument in support of judicial review. The fundamental reason for this Court's holding in Garcia was judicial deference toward a question which was not susceptible to meaningful resolution within the judicial process. The Court was properly concerned that an "unelected" judiciary would interpose itself in decision making which was

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(FOOTNOTE CONTINUED)

Labor Standards Act challenged in Garcia applied to all employees, both public and private. State and local governments unsuccessfully challenged this application on Tenth Amendment grounds. TEFRA, however, affects only the states. It eliminates an entire category of tax-exempt debt formerly available only to states. TEFRA, therefore, is not a Commerce Clause based enactment, applicable by its terms to the whole nation, from which the states seek an exemption. It is tax legislation which impairs the function of the states as states, not as operators of a particular enterprise or providers of a particular service.

essentially political (i.e., legislative) in nature.

The present case presents no such dilemma. No bright line need be drawn to reach the conclusion that the state's fundamental revenue processes are beyond the constitutional reach of federal legislation. The fact that state delegates to the federal legislature participated in the decision process does not bear upon the constitutionality of the legislation which resulted in this case. Pollock v. Farmers Loan & Trust Co., 157 U.S. 429 (1895) remains the law with respect to the constitutional inability of federal taxation to reach state municipal bonds. Garcia's reservation of judicial review should properly be called upon in this case to invalidate TEFRA 301(b)(1).

The raising of revenue is not merely a function which states are reluctant to abandon because they have traditionally enjoyed its exercise. The ability to effectively and efficiently raise revenues to provide essential public services, particularly at a time when federal budget constraints dictate an even larger role for the states, is of crucial importance to the states' continued ability to perform their roles as sovereign entities in the federal system.

The ability to decide how revenue is to be raised and spent is an inherent aspect of sovereignty. Sovereign governments must be free to determine how revenue is raised and how it is appropriated if their ability to govern and provide needed services is not to be impaired. Legislation which effectively

restricts the choices of revenue producing activity available to the states violates a "postulate which limits and controls" Congressional action, the postulate of fiscal self-determination.

The structure of the federal system plainly contemplates sovereign states with powers reserved to them. This reservation of power is meaningless if states cannot make the necessary decisions, or cannot raise the funds, to exercise these powers. No sweeping reading of the Tenth Amendment is required to hold that the notion of sovereignty is hollow if the sovereign cannot determine its own fiscal affairs. TEFRA 310(b)(1) impermissibly infringes on that power. Amici respectfully submit that it unconstitutionally

impairs the sovereignty of the states by restricting the states' ability to carry out their functions in the federal system. This Court should declare it unconstitutional.

CONCLUSION

For the foregoing reasons, _amici_ urge this Court to find in favor of plaintiffs and respectfully urge the Court to find that TEFRA 301(b)(1) in imposing a tax on the interest of state and municipal bonds if not issued in registered form, is unconstitutional.

Respectfully submitted,

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No. 94, Original

IN THE

Supreme Court of the United States

OCTOBER TERM, 1986

STATE OF SOUTH CAROLINA,
Plaintiff,

NATIONAL GOVERNORS' ASSOCIATION,
Plaintiff-In-Intervention,

v.

JAMES A. BAKER, III, SECRETARY OF THE TREASURY OF THE UNITED STATES OF AMERICA,
Defendant.

BRIEF OF THE PUBLIC SECURITIES ASSOCIATION AS *AMICUS CURIAE* IN SUPPORT OF THE PLAINTIFF AND THE PLAINTIFF-IN-INTERVENTION

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BRIEF OF THE PUBLIC SECURITIES ASSOCIATION AS *AMICUS CURIAE* IN SUPPORT OF THE PLAINTIFF AND THE PLAINTIFF-IN-INTERVENTION

INTEREST OF *AMICUS CURIAE*

The Public Securities Association ("PSA") is a national trade organization of approximately 300 members, predominantly broker-dealers and banks, who are active participants in the capital market for State and local debt obligations, commonly referred to as municipal bonds. PSA's members underwrite more than 95 percent of the new issues of municipal bonds sold publicly in the United States each year. Its members are also active participants, as broker-dealers, in

secondary market activity. PSA's members frequently serve as financial advisors to State and local governments in the structuring, sale and delivery of municipal bond issues. Among PSA's stated purposes and an important focus of its activities is the preservation of a stable, efficient and orderly municipal bond market directed toward meeting the financial needs of State and local governmental issuers.[1]

As the Special Master noted in the Report, the municipal bond market is both large and varied. Report at 20-23. There are approximately 47,000 issuers of municipal bonds, ranging in size from the largest States to the smallest school districts. Bonds are issued to meet immediate cash-flow needs and to finance all manner of public facilities and programs. The ability of State and local governments to borrow is essential; indeed, it is inextricably related to their ability to function as governments providing the public services and capital projects required and expected by their citizens.

State and local borrowing needs have grown substantially in recent years and will continue to grow in the future. In 1983, the volume of new long-term issues of municipal bonds was in excess of $83 billion. Report at 20. By 1986, that volume had risen to $147.3 billion. Public Securities Association, *Munici-*

[1] A general summary of some of the salient characteristics of this particular capital market is set forth in the Report of Special Master Samuel J. Roberts (the "Report") submitted to the Court on January 22, 1987 and in the underlying Transcript and Stipulation of Facts. PSA members are also active participants in other public securities capital markets including United States government and Federal Agency securities, as well as mortgage-backed securities.

pal Market Developments (1987). These increased borrowing needs can be met only if State and local issuers can rely upon ready market access to obtain funds at a reasonable cost. That access is affected by the perceptions that other market participants have of State and local issuers as independent governmental entities operating in a federal system.

The municipal bond market has existed since the Colonial Period and has grown and evolved over the same period of history during which the principles of federalism raised in this case have been formed and applied. It is a specialized market, largely separated from other capital markets serving the private sector, the federal government and other borrowing entities. It has developed and grown in response to State and local governmental borrowing needs and is responsive to the particular issuing constraints and requirements of State and local governmental issuers. *See generally* L. Chernak, *The Law of Revenue Bonds* (1954).

During its modern history, the municipal bond market has been marked by two signal characteristics. First, since the late nineteenth century, the market has enjoyed high investor confidence because of its stability and liquidity, and the repayment reliability of State and local governmental issuers. That hallmark of stability and reliability had not always prevailed and the efforts of this Court were required to restore it during the period following the Civil War. *See* VI C. Fairman, *History of the Supreme Court of the United States* 918-1101 (1971). The second signal characteristic is that municipal bond interest, as confirmed in the landmark decision of this Court in *Pollock v. Farmers' Loan and Trust Co.*, 157 U.S. 429 (1895), is exempt from federal income taxation.

The principles potentially at issue in this case are of vital importance to the maintenance and continuation of a stable, efficient and orderly municipal bond market. Investor confidence in the municipal bond market has always been premised on the sovereign status of State and local issuers. An essential element of that sovereign status is the constitutional protection from taxation, based on the doctrine of intergovernmental tax immunity, afforded the interest payable on municipal bonds. From a market perspective, that doctrine is not an abstract or formalistic concept. Rather, the doctrine assured investors that the municipal bond contract made by a State or local governmental issuer cannot be limited or affected by federal income taxation or by intrusive federal regulatory intervention. The fragility of investor reliance is not speculative and it cannot be overestimated. For example, in 1986, Senator Packwood brought municipal bond trading to a virtual halt simply by making statements concerning theoretical changes in the federal tax treatment of municipal bonds.[2]

Because of the importance of the issues raised to the stability and efficiency of the municipal bond market, PSA submits this *amicus* brief in support of the plaintiff, the State of South Carolina, and the plaintiff-in-intervention, the National Governors' Association.

STATEMENT OF THE CASE

PSA endorses and adopts the Statements of the Case and Statements of Facts set forth in the briefs filed by South Carolina and the National Governors' Association.

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[2] *See, e.g.*, Wall St. J., Mar. 20, 1986, at 47, col. 1.

SUMMARY OF ARGUMENT

The registration requirement imposed by Section 310(b)(1) of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA")[3] is not a tax, but is intended to regulate the behavior of the States and exact a penalty for noncompliance. Accordingly, the proper constitutional analysis tests the statute under the Tenth Amendment. Section 310(b)(1) is unconstitutional because it is an attempt by Congress to regulate an essential sovereign function reserved to the States and it imposes an impermissible regulatory penalty to enforce compliance.

South Carolina also challenges the constitutionality of Section 310(b)(1) under the Sixteenth Amendment and the doctrine of intergovernmental tax immunity, but it is unnecessary for the Court to reach these constitutional issues to resolve this case.

In the event the Court determines it must consider the tax immunity issues, it should apply *Pollock v. Farmers' Loan and Trust Co.*, 157 U.S. 429 (1895), to invalidate Section 310(b)(1). The rationale of *Pollock* and intergovernmental tax immunity is soundly based in constitutional principles of federalism. Because the registration requirement directly interferes with the States' sovereign power to borrow, Section 310(b)(1) violates the doctrine of intergovernmental tax immunity. Moreover, Section 310(b)(1) is not authorized by the Sixteenth Amendment.

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[3] Pub. L. No. 97-248, § 310(b)(1), 96 Stat. 596 (1982) (codified at 26 U.S.C. §§ 103(b)(3), 149(a) (Supp. 1987)).

ARGUMENT

I. SECTION 310(b)(1) IS A DIRECT REGULATION OF THE STATES WHICH IS UNCONSTITUTIONAL UNDER A TENTH AMENDMENT ANALYSIS.

A. Section 310(b)(1) Is A Regulatory Penalty And Not A Tax.

TEFRA Section 310(b)(1) is a regulation that requires State and local governments to issue municipal bonds in registered form, and imposes, as a penalty for noncompliance with the regulation, a tax on interest paid on such bonds. Section 310(b)(1) was not intended to produce revenue and, as the Special Master found, has not done so; "[r]ather, it functions as the linchpin of a regulatory scheme designed to insure that all publicly sold debt securities be issued exclusively in registered form." Report at 34. Justice Blackmun, in an earlier opinion in this case, found "evident" that it was not the purpose of Section 310(b)(1) "to produce revenue." *South Carolina v. Regan*, 465 U.S. 367, 384 (1984) (Blackmun, J., concurring). Since its enactment, all State and local obligations have been issued in registered form. Thus, Section 310(b)(1) has been supremely effective in accomplishing the regulatory purpose Congress intended. Consequently, Section 310(b)(1), far from being a tax, is a regulation that violates, as shown below, Tenth Amendment federalism principles by intruding upon the sovereignty of the States.

Congress cannot escape scrutiny of the constitutionality of an enactment by denominating a regulation as a tax. The Court has on several occasions declared invalid the penalty provisions in tax statutes that seek to ensure compliance with a regulation concerning activities beyond the federal power to regu-

late.[4] *United States v. Kahriger*, 345 U.S. 22, 31 n.10 (1953) (and cases cited therein), *overruled on other grounds, Marchetti v. United States*, 390 U.S. 39 (1968). In *United States v. Constantine*, 296 U.S. 287, 292-96 (1935), the Court invalidated a purported excise tax on retail liquor traffic that had as its only purpose the imposition of additional penalties for violations of State law. The exorbitant amount exacted by the purported tax demonstrated conclusively the purely regulatory intent underlying the statute. The statute violated Tenth Amendment principles because it intruded upon the States' rights to impose sanctions for violations of State law, which is reserved to the States by the Constitution. Thus, an area in which the federal government cannot intrude directly could not be reached indirectly by styling a regulation as a tax. *See also Child Labor Tax Case*, 259 U.S. 20 (1922); *Hill v. Wallace*, 259 U.S. 44 (1922). In these cases, the penalty provisions concerned activities reserved to the States to regulate. The registration re-

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[4] The Special Master cites *Veazie Bank v. Fenno*, 75 U.S. (8 Wall.) 533 (1869), for the proposition that a purely regulatory tax can be sustained as a means of implementing another delegated power. Report at 189. In *Veazie Bank*, the tax was imposed on a state-chartered bank pursuing purely private activities, *id.* at 547-48, and was actually collected by the Collector of Internal Revenue. *Veazie Bank* thus is distinguishable because the tax in that case sought to regulate purely private, rather than State, activities and was actually imposed and collected. Moreover, *Veazie Bank* recognized the principle that the broad language of the federal taxing power cannot be used to invade the rights of the States reserved under the Tenth Amendment. *Id.* at 547. *See also* Report at 95. Consequently, that case does not support imposition of a purported tax purely for regulatory purposes, such as Section 310(b)(1).

quirement goes further and regulates the conduct of the States in the exercise of a sovereign activity.

The fact that the putative tax in this case is used to enforce a federal regulatory scheme does not establish its validity, particularly where it fails to generate any revenue. The Court has upheld tax provisions imposed upon noxious goods or activities where the accompanying regulations are designed to enforce compliance with the related tax provisions and the tax actually generated revenue. *E.g., Kahriger*, 345 U.S. 22 (registration requirement for persons engaged in wagering and accompanying occupational tax held valid); *United States v. Sanchez*, 340 U.S. 42, 44 (1950) (Court considered attack on "regulatory character and prohibitive burden" of tax on transfer of marijuana); *Sonzinsky v. United States*, 300 U.S. 506, 512-14 (1937) (Court considered whether "statute contain[ed] regulatory provisions related to a purported tax . . . that . . . is a penalty resorted to as a means of enforcing the regulations"); *United States v. Doremus*, 249 U.S. 86 (1919) (regulatory provisions were designed to enhance collection of tax to which they were reasonably related and which was a true tax that generated revenue). Whether a purported tax is a valid exercise of the taxing power with the necessary accompanying regulatory effect as opposed to an invalid penalty depends fundamentally upon whether the tax was intended to obtain revenue. *Sonzinsky*, 300 U.S. at 514. As indicated above, Congress did not intend that Section 310(b)(1) would raise revenue and, as the Special Master found, it has not produced any revenue. Since Section 310(b)(1) does not impose a tax, its regulatory aspect is, by definition, unrelated to it. Section 310(b)(1), therefore, is

not a valid exercise of the taxing power.[5]

B. Section 310(b)(1) Is Invalid Under The Tenth Amendment Because It Is Overly Intrusive Of The Reserved Powers Of The States.

In Section 310(b)(1), Congress purports to impose a tax on the States' issuance of bearer bonds, while the intent and effect of Section 310(b)(1) is solely to regulate an area reserved to the States under our constitutional system. It is beyond dispute that protection of State sovereignty within our system of federalism was a vital consideration in the creation of the national government. *See Garcia v. San Antonio Metropolitan Transit Authority*, 469 U.S. 528, 550-51 (1985); *id.* at 568-70 (Powell, J., dissenting); *id.* at 580-82 (O'Connor, J., dissenting). "Our Federalism" recognizes that the States as sovereign entities have legitimate interests separate from those of the national government. Our constitutional system is designed to safeguard the States from an overbearing Congress. The diffusion of power and responsibilities between the national government and the States ensures the continued existence of a vital republic responsive to the needs of its citizenry. *Id.*

The constitutional system of federalism upon which this country was founded, and upon which its contin-

[5] The Special Master suggests in his analysis that even if Section 310(b)(1) is not a valid regulation in aid of the taxing power it may still be sustained under the commerce power. Report at 128, 190. Congress has not attempted in Section 310(b)(1) to regulate interstate commerce in bearer bonds by, for example, prohibiting their transportation across State lines. This Court should not speculate as to the form and substance of such a hypothetical regulation, particularly when such a regulation could well be less intrusive on the States' sovereignty.

ued existence depends, relies upon the continued respect of the federal government for the reserved powers of the States. As demonstrated by the National Governors' Association, whose argument we support and adopt, the decisions of this Court consistently recognize the importance of safeguarding the States from intrusive federal regulation. *E.g.*, *Garcia*, 469 U.S. at 555-56 (the constitutional structure imposes affirmative limits on federal action); *FERC v. Mississippi*, 456 U.S. 742, 761 (1982) ("the power to make decisions and to set policy is what gives the State its sovereign nature"); *Fry v. United States*, 421 U.S. 542, 547 n.7 (1975) (the Tenth Amendment expresses the constitutional postulate that Congress may not exercise its power to impair the States' integrity). In *Younger v. Harris*, 401 U.S. 37 (1971), the Court relied on federalism principles to hold that, under certain circumstances, federal courts must refrain from intruding on the right of a State to enforce its own laws. While *Younger* concerned intrusion by the federal judiciary, as opposed to the federal legislative branch, it is founded on the principle that States as independent sovereigns must have the ability to perform certain functions free from federal interference.

Although Section 310(b)(1) purports to impose a tax on the issuance of bearer bonds, Congress actually seeks to regulate the States' exercise of their borrowing power. This regulation intrudes in an area clearly reserved to the States in our constitutional system of federalism and thus plainly violates the Tenth Amendment. Section 310(b)(1) is not a valid tax because it is not designed to produce any revenue and in fact fails to do so. Instead, it is a penalty

enacted solely to force the States to comply with a regulation that intrudes on a sovereign activity reserved to the States by the Tenth Amendment.

II. THE COURT NEED NOT READDRESS THE INTERGOVERNMENTAL TAX IMMUNITY PRINCIPLES ESTABLISHED IN *POLLOCK*.

This Court has sustained tax regulations only where an actual tax was imposed and the challenged regulations were designed to enhance collection of the particular tax. It has not sustained a putative tax imposed by the federal government solely as a penalty to force compliance with a regulation, and it should not do so here, where the regulated activity involves the exercise by State and local governments of their borrowing power. This case can and should be decided on that basis and there is no need to reach intergovernmental tax immunity.

Pollock v. Farmers' Loan and Trust Co., 157 U.S. 429 (1895), has stood for over 90 years as a firm holding of this Court. It has continuously provided protection from federal tax intrusion to one of the most important sovereign functions of the States. The principles estabiished by the *Pollock* holding are a core aspect of federalism at least as important as the location of a State capitol, *Cf. Coyle v. Smith*, 221 U.S. 559 (1911), and should not lightly be reexamined. If Section 310(b)(1) of TEFRA were a federal revenue-generating measure, the *Pollock* holding would be directly implicated. Revenue production is not, however, the purpose or intent of the registration requirement. *See South Carolina*, 465 U.S. at 384 (Blackmun, J., concurring). The Special Master readily acknowledged that the *Pollock* holding is not a subject for reexamination in this case. Report at 143-44, 184

n.486. Furthermore, he concluded that the record has not been developed in a manner to permit such reexamination.

Contrary to the Special Master's analysis, it is unnecessary to address the intergovernmental tax immunity issue at all since the case can be resolved on Tenth Amendment grounds. A fundamental tenet of constitutional decisionmaking is that questions unnecessary to the decision in a particular case will not be addressed. Indeed, Justice O'Connor's concurrence in granting South Carolina leave to file its complaint in this case stated, "it is this Court's longstanding practice to avoid resolution of constitutional questions except when absolutely necessary." *South Carolina*, 465 U.S. at 398 (O'Connor, J., concurring). From that general rule, the Court has developed specific principles of constitutional adjudication that direct against consideration of the tax immunity issue. Justice Brandeis' oft-cited concurrence in *Ashwander v. Tennessee Valley Authority*, 297 U.S. 288, 345-48 (1936) (Brandeis, J., concurring), is probably the most succinct analysis of the principles of constitutional decisionmaking.[6] Justice Brandeis restated the principles and proceeded to develop a "series of rules" for applying them. *Id.* at 345-47. These principles suggest that the Court should be reluctant in this case to revisit intergovernmental tax immunity. First, reexamining the

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[6] One scholar described this opinion as representative of "one of the truly major themes in Brandeis' judicial work: the conviction that the Court must take the utmost pains to avoid precipitate decision of constitutional issues, and that it must above all decide such issues only when it is absolutely unable otherwise to dispose of a case properly before it." A. Bickel, *The Least Dangerous Branch* 2-3 (1962).

tax immunity issues would "anticipate" a question of constitutional law because no tax has been imposed here.[7] *Id.* at 346-47. Second, a decision on those grounds would be far " 'broader than is required' " by the facts of this case, which may be disposed of on the narrower, more fact-specific Tenth Amendment grounds. *Id.* at 347 (citation omitted).

Clearly, a "rule of constitutional law" founded on the Tenth Amendment is the narrowest ground upon which to decide this case. Substantially all of the evidentiary presentation of the plaintiff and the Secretary focused on such Tenth Amendment issues as the nature of the intrusion on State sovereignty visited by compliance with Section 310(b)(1) of TEFRA, the federal objectives sought to be achieved by the regulatory provision and the legislative process pursuant to which Section 310(b)(1) was enacted. The developed record contains classic Tenth Amendment factual analysis and is largely irrelevant to the Sixteenth Amendment and intergovernmental tax immunity issues. Deciding this case on those latter grounds would be inconsistent with the Court's historical practice in constitutional jurisprudence. *E.g.*, *Crowell v. Benson*, 285 U.S. 22, 62 (1932).

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[7] This issue would be directly presented by a challenge to provisions of the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085. For example, the alternative minimum tax as it affects municipal bonds or the inclusion of municipal bond interest in determining the tax on Social Security benefits would directly raise the issue. *See* 26 U.S.C. § 86. Cases under these statutes may well be presented to this Court. Indeed, one such case has already produced a petition for certiorari. *Goldin v. Baker*, 809 F.2d 187 (2d Cir. 1987), *petition for cert. filed*, 55 U.S.L.W. 3714 (U.S. Apr. 10, 1987) (No. 86-1647).

In measuring the constitutional validity of Section 310(b)(1), it should be seen and assessed for what it plainly is—a regulatory penalty and not a tax. The Court's careful practice in confronting constitutional decisionmaking should be followed in this case to avoid an unnecessary and premature reexamination of the intergovernmental tax immunity principles established in *Pollock*.

III. THE DOCTRINE OF INTERGOVERNMENTAL TAX IMMUNITY PROHIBITS APPLICATION OF THE TAX SANCTION OF SECTION 310(b)(1).

If the Court addresses the doctrine of intergovernmental tax immunity in this case, it should hold that *Pollock v. Farmers' Loan and Trust Co.*, 157 U.S. 429 (1895), precludes the application of the threatened tax under Section 310(b)(1) of TEFRA. The Special Master's Report confuses, and in some part obfuscates, the relevant facts, the applicable law, and the constitutional imperative of federalism reflected in *Pollock*.

Contrary to the Special Master's recommendation, *Pollock* renders unconstitutional the imposition by the federal government of any tax on the issuance of a State debt obligation. This Court has consistently recognized the validity of intergovernmental tax immunity and the importance of that doctrine to the sovereign existence of the States in our dual system of government. *E.g., Massachusetts v. United States*, 435 U.S. 444, 454-60 (1978) (opinion of Brennan, J.); *New York v. United States*, 326 U.S. 572, 589 (1946) (Stone, C.J., concurring); *Helvering v. Gerhardt*, 304 U.S. 405, 414 (1938); *Metcalf & Eddy v. Mitchell*, 269 U.S. 514, 523-24 (1926). The Special Master's proposed modern synthesis of intergovernmental tax im-

munity breaks with all precedent by suggesting that no area of State sovereignty is free from taxation by the federal government if such a tax is nondiscriminatory, if the impact of the tax does not threaten the continued existence of the States and if the tax does not unduly interfere with the States' ability to perform essential government functions. Report at 181. The Report fails totally to account for the history of bearer bonds as the universal means of State and local borrowing, the continued vitality of *Pollock*, and the Sixteenth Amendment's nonapplicability to interest on State and local debt.

A. The Tradition Of Bearer Bond Financing.

From their genesis, State and local governments have issued bearer bonds, a practice drawn from commercial finance practices in England. *Cf.* Bouveier's Law Dictionary at 694 (Rawle's 3d Rev. 1914). State and local governments exercised their borrowing power through the issuance of bearer bonds long before there was ever a federal income tax. Bearer bonds have a purpose wholly independent of any tax laws in that they place in the hands of the holder the independent ability to receive interest promptly and transfer ownership quickly, simply and inexpensively. *Cf. Aurora City v. West*, 74 U.S. (7 Wall.) 82, 105 (1868); *Benwell v. Newark*, 55 N.J. Eq. 260, 36 A. 668 (1897).

Until TEFRA, State and local governments, in the exercise of their sovereign functions of borrowing for public needs, universally used the bearer bond form of borrowing. Since the effective date of Section 310(b)(1), however, all State and local government bonds have been issued in registered form. TEFRA

thus caused a complete reversal in State and local government practice.[8] Report at 23-24.

The ability of State and local governments to borrow money, in the manner and in the capital market that they choose, is a fundamental aspect of their sovereignty and is inherent in and necessary for their independent existence. That fundamental borrowing power existed before the States and their citizens devised that compact among the States, the Constitution. Surely no State ratifying the Constitution contemplated that it was authorizing the federal government to dictate its borrowing practices. Moreover, that borrowing power existed unimpeded by federal regulatory or tax measures when the States ratified the Sixteenth Amendment to enable the federal government to levy a direct, non-apportioned income tax. The Sixteenth Amendment did not expand the reach of the federal taxing power to authorize the levy of a federal income tax upon State and local interest on debt obligations.[9]

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[8] The universal compliance by State and local governments demonstrates conclusively that the penalty for non-compliance—a threatened tax on interest income—would be a severe and direct burden on the exercise of the sovereign power to borrow money for public purposes. Undisputed evidence before the Special Master proved that such a tax, if imposed, would increase interest costs to State and local governments by 28 percent to 35 percent. Transcript at 443, 618. This establishes that the imposition of this tax on a State and local governmental issuer who chose to issue bearer bonds would be a tax upon its sovereign authority to exercise its borrowing power. Moreover, more than increased borrowing costs would likely result since such issues would no longer have access to the same capital market.

[9] *See Metcalf & Eddy*, 269 U.S. at 521; discussion of the legislative background of the ratification of the Sixteenth Amendment, *infra*, at 27.

Throughout the history of the nation, State and local governments borrowing for their needs have been, by longstanding interpretation of the Constitution, free from federal taxation. The Secretary and the Special Master rewrite fact and history when they imply that the immunity of municipal bonds from federal taxation stems from any sort of conditional grant or benefit from the federal government. Report at 78, 126-28. Nor is there any basis for the Special Master's suggestion that Section 310(b)(1) "merely alters the economic calculus" underlying the States' choice of debt issuance. *Id.* at 126. The exemption from federal income tax of interest paid on State and local debt is grounded firmly in the Constitution. Nothing before or after *Pollock* has altered that fundamental truth.

B. *Pollock* Requires The Court To Invalidate Section 310(b)(1).

The doctrine of intergovernmental tax immunity was recognized by this Court in *M'Culloch v. Maryland*, 17 U.S. (4 Wheat.) 316 (1819), which held unconstitutional a tax imposed by the State of Maryland on a bank chartered by Congress. Shortly thereafter, in *Weston v. City Council of Charleston*, 27 U.S. (2 Pet.) 449, 481 (1829), this Court specifically held that one sovereign government could not constitutionally tax the obligations of another sovereign. Chief Justice Marshall's opinion for the Court in *Weston* reiterated Hamilton's observation in The Federalist that our federal system, in which more than one sovereign is charged with public responsibilities (and each is given an attendant power to raise revenue), "might require reciprocal forbearances." A. Hamilton, *The Federalist No. 32* 202 (J. Cooke ed. 1961). Finally, in *Pollock*,

the Court ruled unconstitutional the federal Revenue Act of 1894, which imposed a federal tax on the interest paid on State debt obligations. 157 U.S. at 586. In expressly holding that such interest was constitutionally immune from federal income taxation, the Court stated:

> the tax in question is a tax on the power of the States and their instrumentalities to borrow money, and consequently repugnant to the Constitution.

Id. Pollock is the only Supreme Court case ever to consider the validity of the imposition of federal income tax on municipal bond interest. As it pertains to that issue, *Pollock* remains sound law and forms an essential basis for the participation of State and local governments in the municipal bond market.

Notwithstanding the Special Master's interpretation to the contrary, Report at 164-81, this Court has never wavered in its recognition that intergovernmental tax immunity is a basic concept of constitutional magnitude, founded on fundamental principles of federalism and the concomitant respect of one sovereign for another. The constitutional purpose of tax immunity since its inception has remained constant: "to protect the States from undue interference with their traditional governmental functions." *Massachusetts*, 435 U.S. at 459. The "undue interference" from which States are protected need not be particularly burdensome or threatening so long as it is the State being taxed because it is taxation of the State that infringes State sovereignty and offends constitutional notions of federalism. *New York*, 326 U.S. at 587

(Stone, C.J., concurring).[10]

While the Court has consistently adhered to the rationale of intergovernmental tax immunity, the precise contours of a sovereign's "government functions" are not clearly defined. *See New York*, 326 U.S. 572. The Special Master, however, did not even attempt to determine how the contours of intergovernmental tax immunity fit this case. Instead, the Special Master proposed a new test for application of the doctrine:

> To prevail on their claim that the tax sanction violates the State's constitutional tax immunity, plaintiffs must show that the sanction operates to discriminate against the States. Failing that, plaintiffs might still prevail if they could demonstrate that the actual impact of the sanction threatens the continued

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[10] The threatened tax imposed by Section 310(b)(1) would clearly fall directly on the States. The financial markets of today offer a plethora of choices to investors who can move their money from one investment to another very rapidly, even daily or overnight. The imposition of a tax on interest on municipal bonds is not a tax upon investors, for they can immediately change their investments, demanding and readily obtaining higher interest on other taxable investments. Thus, it would be a tax on the borrowing power of the States and local governments. That makes this case unlike every previous case in which this Court has disallowed the claim of immunity voiced by the third party recipient of payments from the States and local governments. Even greater proof of the impact of such legislation on the sovereign power to borrow is the fact that the States and local governments did not view the sanction in Section 310(b)(1) as a tax that some third party would have to bear. Rather, these governments reacted (as intended by Congress) by changing their centuries-old mode of borrowing from bearer to registered bonds to avoid the imposition of the threatened tax on them.

> existence of the States or inerferes [*sic*] unduly with their ability to perform essential government functions.

Report at 181. The Special Master's proposed test emasculates tax immunity by effectively providing that no area of State sovereignty is free from federal taxation. Such a result ineluctably offends constitutional notions of federalism as reflected in *Pollock*, which held that the borrowing power is a central attribute of State sovereignty in our constitutional framework and recognized that interference with that power by the federal government is direct and immediate. There is no need to develop a new, theoretical constitutional standard. The decisions of this Court that the Special Master considers to have undermined *Pollock* did no such thing. These decisions either expressly endorsed *Pollock* or explicitly recognized its rationale of direct interference.

In *Metcalf & Eddy v. Mitchell*, 269 U.S. 514 (1926), the Court upheld the application of federal tax to the income of an independent contractor performing work for States and political subdivisions. The Court nevertheless emphasized that intergovernmental tax immunity protects against interferences with the sovereign powers of State and local governments, stating that debt obligations of State and local governments "sold to raise public funds . . . [are] so intimately connected with the necessary functions of government, as to fall within the established exemption; and when the instrumentality is of that character, the immunity extends not only to the instrumentality itself but to income derived from it." *Id.* at 522 (citing *Pollock*). Although *Metcalf & Eddy* dealt with a general tax not intended to affect the

way the States and local governments conducted their affairs, the Court reasoned that the subject of a tax "may be of such a character or so intimately connected with the exercise of a power or the performance of a duty by one government, that any taxation of it by the other would be such a direct interference with the functions of government itself as to be plainly beyond the taxing power." *Id.* at 524.

Similarly, in *Willcuts v. Bunn*, 282 U.S. 216 (1931), the Court held that the profit from the sale of municipal bonds by an investor could constitutionally be taxed by the federal government. The Court recognized that it is not necessary to protect States against nondiscriminatory federal taxes "where no direct burden is laid upon a governmental instrumentality, and there is only a remote, if any, influence upon the exercise of the functions of government."[11] *Id.* at 225. The Court again cited *Pollock* in contrasting the tax exemption for the principal and interest on State and local bonds because "a tax upon the amounts payable by the terms of the contract has therefore been regarded as bearing directly upon the exercise of the borrowing power of government." *Id.* at 226. The Court found nothing in the record or any basis for judicial notice that the tax on the profit from the sale

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[11] Apparently it is language such as that in *Willcuts* requiring a showing of a substantial burden to invalidate a tax that was seized upon by the Special Master in formulating his proposed standard. *See* Report at 166-67. However, the substantial burden requirement of *Willcuts* was imposed because the taxed transaction was substantially removed from the exercise of the States' borrowing power. Since there was no *direct* interference in the contract by the federal government, the Court properly required a higher showing to invalidate the tax.

of the bonds effected the exercise of the borrowing power of the issuer, *id.* at 230-34, and it was plain that the States and local governments were not asserting any such claim.[12]

In *Helvering v. Gerhardt*, 304 U.S. 405 (1938), the Court denied the claim of an employee of a political subdivision that his compensation was immune from federal income taxation. The Court noted that it would not recognize "immunity when the burden on the state is so speculative and uncertain that if followed it would restrict the federal taxing power without affording any corresponding tangible protection of state government . . . ." *Id.* at 420. The Court reasoned that tax immunity in such cases would secure to States "a theoretical advantage so speculative in its character and measurement as to be insubstantial." *Id.* at 421. By contrast, the Court reaffirmed that

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[12] *See also James v. Dravo Contracting Co.*, 302 U.S. 134 (1937), which held that the income of a federal contractor from its federal contract was not immune from State tax. In distinguishing *Pollock*, the Court said: "There is no ineluctable logic which makes the doctrine of immunity with respect to government bonds applicable to the earnings of an independent contractor rendering services to the Government. That doctrine recognizes the direct effect of a tax which 'would operate on the power to borrow before it is exercised.' " *Id.* at 152-53. Similarly, the Court rejected a private lessee's claim to immunity of income from a lease with a State agency in *Helvering v. Mountain Producers Corp.*, 303 U.S. 376 (1938). The Court noted that *Pollock* exempts income of third parties because a tax on municipal bond income is "a tax bearing directly upon the exercise of the borrowing power of the Government . . ." but noted that "immunity from nondiscriminatory taxation sought by a private person . . . cannot be supported by merely theoretical conceptions of interference with the functions of government." *Id.* at 386.

interest income from municipal bonds was immune from taxation because "the function involved [borrowing money] was one thought to be essential to the maintenance of a state government." *Id.* at 417.

Graves v. New York, 306 U.S. 466 (1939), the mirror image of *Gerhardt*, denied immunity claimed by employees of a federal agency from state income taxation. Again, the Court emphasized that the purpose of immunity is not to provide benefits to third parties "but to prevent undue interference with the one government by imposing on it the tax burdens of the other." *Id.* at 483-84.

Inexplicably, the Special Master interpreted the foregoing cases as undermining *Pollock*, notwithstanding that the Court repeatedly cited *Pollock* with approval. In those cases, the Court was merely defining the broad parameters of intergovernmental tax immunity to preclude payments to third parties where the effect on the governmental body was theoretical and speculative. Not only did those cases fail to impair *Pollock*, they reaffirmed its soundness.

More modern cases have dealt with the intergovernmental tax immunity issue more tangentially, but still support the continued vitality of *Pollock*. In *New York v. United States*, 326 U.S. 572 (1946), the Court held that a nondiscriminatory federal excise tax on mineral waters sold in containers could constitutionally be applied to the sale of mineral waters by a State. A plurality of the Court reaffirmed the doctrine of intergovernmental tax immunity by rejecting any thesis that it does not apply to nondiscriminatory taxes, because "it is plain that the invalidity is due wholly to the fact that it is a State which is being taxed so as unduly to infringe, in some manner, the

performance of its functions as a government which the Constitution recognizes as sovereign." *Id.* at 588 (Stone, C.J., concurring). Justice Frankfurter concurred in the judgment and acknowledged that certain State activities, such as levying taxes and owning a statehouse, "could not be included for purposes of federal taxation in any abstract category of taxpayers without taxing the State as a State." *Id.* at 582 (Frankfurter, J., concurring). The practical impact of permitting the federal government to intrude upon State sovereignty is to remove the principle of federalism from the Constitution:

> "[t]he Constitution is a compact between sovereigns. The power of one sovereign to tax another is an innovation so startling as to require explicit authority if it is to be allowed. If the power of the federal government to tax the States is conceded, the reserved power of the States guaranteed by the Tenth Amendment does not give them the independence which they have always been assumed to have. They are relegated to a more servile status. They become subject to interference and control both in the functions which they exercise and the methods which they employ. They must pay the federal government for the privilege of exercising the powers of sovereignty guaranteed them by the Constitution, whether, as here, they are disposing of their natural resources, or tomorrow they issue securities or perform any other acts within the scope of their police power."

Id. at 595 (Douglas, J., dissenting) (footnote omitted).

Most recently, in *Massachusetts v. United States*, 435 U.S. 444 (1978), the Court held that a federal nondiscriminatory aircraft registration tax, in the nature of a user fee, could be levied on State aircraft without infringing the intergovernmental tax immunity doctrine. In reviewing the history of the tax immunity doctrine, Justice Brennan's plurality opinion focused on the constitutional purpose of the doctrine: "to protect the States from undue interference with their traditional governmental functions." *Id.* at 459. That purpose remains a vital part of our constitutional tradition, yet would be utterly vitiated by the Special Master's supposedly modern formulation. There is no support in any of these cases for this Court to conclude, as the Special Master has, that intergovernmental tax immunity protection does not prohibit the threatened tax of Section 310(b)(1).

In unnecessarily striving for new theoretical concepts, the Special Master propounds at least eight different formulations of the basis for judicial intervention under intergovernmental tax immunity (Report at 146, 147, 168, 171, 173, 175, 177, 181), ranging from requiring that the federal tax have a "substantial and direct effect upon governmental functioning" (*id.* at 171) to that it "cripple State autonomy" (*id.* at 146 n.440). In applying legal analysis to the case, however, the Special Master consistently applies an unreasonably harsh standard—"danger to the States' continued existence" (*id.* at 181-82), "threatening the continued existence of the States as governmental entities" (*id.* at 182), "destructive of their independent existence" (*id.* at 184). This "Armageddon test" would utterly vitiate the doctrine of intergovernmental tax immunity and is not supported

in any manner by the opinions of this Court that the Special Master purportedly relied upon.

The Special Master's approach to tax immunity also smacks more of abstract formalism than of practical reality. If the registration requirement—or any other section or subsection of federal tax legislation—must "threaten the continued existence" of fifty States and their 47,000 subdivisions before it warrants constitutional scrutiny under the intergovernmental tax immunity doctrine, then that doctrine and important federalism principles behind it are dead letters. As one constitutional scholar has observed:

> Of course, no one expects Congress to obliterate the states, at least in one fell swoop. If there is any danger, it lies in the tyranny of small decisions—in the prospect that Congress will nibble away at state sovereignty, bit by bit, until someday essentially nothing is left but a gutted shell.

L. Tribe, *American Constitutional Law* § 5-20 (1978).

The Special Master's new formulation of tax immunity is not correct. Time-honored precedents demonstrate plainly that the incursion by Congress in Section 310(b)(1) goes too far. In the light of the facts here, where the threatened tax would clearly, directly and intentionally impact the borrowing power of the States and local governments, *Pollock* mandates that Section 310(b)(1) is unconstitutional. To ignore that and uphold Section 310(b)(1) on the basis of the totally unsupported assumption that such a burdening of the States and local governments in their sovereign functions will further federal tax compliance would eviscerate fundamental principles of federalism. The

enactment of Section 310(b)(1) is a breach of faith with the States under the compact that is our Constitution.

C. The Sixteenth Amendment Does Not Authorize A Tax On The Interest Paid On State And Local Debt.

Finally, PSA fully supports the analysis set forth in the brief of *amicus curiae*, Government Finance Officers Association, demonstrating that the Sixteenth Amendment excludes by the original intention of its Framers any power for Congress to levy a tax on State and local government debt obligations. Ratification of the Sixteenth Amendment was secured only after public assurances to the States by the sponsors of the Amendment that it would not authorize the taxation of municipal bonds. The assurances were given after Governor Hughes of New York had recommended against ratification for fear the Amendment contained such authority. *See* 45 Cong. Rec. 1694-98 (Feb. 10, 1910) (statement of Sen. Borah); 45 Cong. Rec. 2245-47 (Feb. 23, 1910) (statement of Sen. Brown). Before February 10, 1910 and such reassuring representations, only two States had ratified the Sixteenth Amendment. U.S.C.A. Const. Amend. XVI (Historical Note). Surely, this ratification process, premised on an explicit understanding that the proposed amendment would not reach municipal bond interest, establishes that the scope of the Sixteenth Amendment is more narrow than the Special Master believed. Contemporaneous history and purpose are traditional guides to the interpretation of constitutional amendments. *Slaughter-House Cases*, 83 U.S. (16 Wall.) 36, 67-68 (1872). Thus, the Sixteenth Amendment affords no support for Section 310(b)(1).

The Special Master acknowledged that this Court has consistently held that the Sixteenth Amendment did not extend the scope of the federal taxing power. *See Metcalf & Eddy*, 269 U.S. 514. However, the Special Master characterizes the important interchanges between congressional and State political leaders as merely conversations reflecting the prevailing view of the intergovernmental immunity doctrine. Report at 163 n.463. His characterization unjustifiably diminishes the significance and importance of the understandings sought by and given to the States in connection with their ratification of the Amendment. *See Slaughter-House Cases*, 83 U.S. (16 Wall.) at 67-68.

CONCLUSION

The Court should resolve this case in favor of South Carolina under the principles of constitutional federalism embodied in the Tenth Amendment and on the basis that the tax sanction imposed by Section 310(b)(1) constitutes an impermissible penalty under those same principles. If the Court reaches the issue of the applicability of the doctrine of intergovernmental tax immunity, the Court should determine that Section 310(b)(1) unconstitutionally imposes a threatened tax on income derived from debt obligations issued by the States and their political subdivisions.

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(8)

No. 94, Original

IN THE
Supreme Court of the United States

October Term, 1986

STATE OF SOUTH CAROLINA,
Plaintiff,

NATIONAL GOVERNORS' ASSOCIATION,
Plaintiff-in-Intervention,

v.

JAMES A. BAKER, III, SECRETARY OF THE TREASURY OF THE UNITED STATES OF AMERICA,
Defendant.

MOTION FOR DIVIDED AND EXTENDED ARGUMENT

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May 26, 1987

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No. 94, Original

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Defendant.

MOTION OF PLAINTIFF-IN-INTERVENTION FOR DIVIDED AND EXTENDED ARGUMENT

The National Governors' Association ("NGA"), plaintiff-in-intervention, respectfully requests that this Court grant extended and divided argument so that each side, plaintiffs and defendant, will receive 50 minutes at oral argument and further, that plaintiffs' 50 minutes will be divided between the plaintiff, South Carolina and the plaintiff-in-intervention, NGA.*

* South Carolina has informed the National Governors' Association that it is filing a parallel motion requesting extended and divided argument.

PRELIMINARY STATEMENT

On February 7, 1983, South Carolina sought leave to file an original complaint in the United States Supreme Court challenging the constitutionality of Section 310(b)(1) of the Tax Equity and Fiscal Responsibility Act of 1982; that Section provides that the interest paid on municipal bonds will be tax exempt only if those bonds are issued in registered, as opposed to bearer, form. The gravamen of South Carolina's complaint was that Section 310(b)(1), by effectively requiring the States to submit to the burden of issuing their obligations in registered form, violated the doctrine of intergovernmental tax immunity and the Tenth Amendment to the Constitution.

This Court granted South Carolina leave to file on February 22, 1984. *South Carolina* v. *Regan*, 465 U.S. 367 (1984). In doing so, it adverted to the important federalism issues raised by this case. Thus, Justice Brennan wrote for the Court that "[u]nquestionably, the manner in which a State may exercise its borrowing power is a question that is of vital importance to all 50 States." *South Carolina v. Regan*, 465 U.S. 367, 382 (1984). In addition to granting South Carolina's motion, the Court appointed a Special Master, the Honorable Samuel J. Roberts, to develop a factual record.

The NGA subsequently filed a motion for leave to intervene as a plaintiff. As an association of the States, the members of which are the chief executives of the fifty States, two Commonwealths and three Territories, the NGA represents the States in the federal system. Its motion to intervene was premised on the ground that the "members of the NGA [would] be bound by the judgment and have a substantial interest in the outcome." *Motion of the National Governors' Association for Leave to Intervene as Plaintiff* at 2. The NGA stressed that it would be able to provide the Court with a broad national perspective, drawing upon and demonstrating the impact of the Section on the fifty states. The Special Master recommended that the motion for leave to intervene be granted and in his Report found that the "NGA's

contribution to the fact-finding process has been substantial and has materially aided the Special Master in discharging his duties." (Report at 4 n. 7).

I.

Divided Argument Is Essential To Represent The Now Divergent Views of Plaintiff and Plaintiff-in-Invervention

As this case has developed, NGA and South Carolina have adopted incompatible legal positions. This divergence of views makes divided argument essential to a full airing of the issues.

From the outset, South Carolina has asserted that Section 310(b)(1) imposes a federal tax on state debt obligations in violation of the doctrine of intergovernmental tax immunity.* At this juncture, the NGA argues that the single constitutional issue raised in this case is whether requiring the States to register their bonds is fundamentally antithetical to the notion of federalism contemplated by the structure of the Constitution and the Tenth Amendment.

While South Carolina clearly views Section 310(b)(1) as imposing a tax on the States, the NGA premises its entire argument on the notion that Section 310(b)(1) is not a tax, but a regulation in aid of Congress' taxing power. *Exceptions of the National Governors' Association to the Report of the Special Master and Brief in Support Thereof* at 23-24 (filed May 9, 1987). As a result, the NGA believes that this Court should not reach the tax immunity issue presented by South Carolina.

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* South Carolina also agrees that Section 310(b)(1) raises a Tenth Amendment issue.

Because South Carolina and the NGA present divergent views as to whether the intergovernmental tax immunity issue is raised by Section 310(b)(1), NGA respectfully submits that argument should be divided to permit the full presentation of each point of view.

II.

The Complexity and Importance of the Question Presented Requires Extension of Time for Argument

The issues presented by this case are both complex and important. After appointment of the Special Master, the parties engaged in two years of discovery and three weeks of hearings before the Master. The intricacy of the issues is reflected in the Special Master's Report which required 193 printed pages to discuss and analyze the questions of fact and law presented.

In addition to the complexity of the questions presented, the case also raises important issues of law, one still unsettled and the other long-dormant. The case puts forward for the first time since *Garcia v. San Antonio Transit Authority*, 469 U.S. 528 (1985) the troubling question of the limits imposed by the Constitution on Congress' ability to regulate the States, and in particular, the ability of Congress to use state legislative and administrative resources to accomplish federal ends. Under NGA's approach, this case presents an important issue left open in *FERC v. Mississippi*, 456 U.S. 742 (1982): the extent to which Congress may constitutionally regulate the states in a manner that obliges them to enact new laws to meet a federal directive. Under South Carolina's approach, this case requires the Court to rule on the continuing vitality of the principle that interest on state governmental debt cannot be subject to federal taxation. *See Pollack v. Farmers' Loan & Trust Co.*, 157 U.S. 429 (1895).

The parties thus require an extended period of argument to adequately present the issues.

CONCLUSION

For the foregoing reasons, the NGA respectfully requests the Court to grant divided and extended argument.

Respectfully submitted,

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May 26, 1987

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No. 94, Original

In the Supreme Court of the United States

OCTOBER TERM, 1987

STATE OF SOUTH CAROLINA, PLAINTIFF

NATIONAL GOVERNORS' ASSOCIATION,
PLAINTIFF IN INTERVENTION

v.

JAMES A. BAKER, III,
SECRETARY OF THE TREASURY

ON THE REPORT OF THE SPECIAL MASTER

BRIEF FOR THE DEFENDANT

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QUESTIONS PRESENTED

1. Whether Section 310(b) of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), which provides in pertinent part that the interest paid on publicly offered long-term bonds issued by state and local governments is exempt from federal income tax only if the bonds are issued in registered form, violates the Tenth Amendment.

2. Whether Section 310(b) of TEFRA, as applied to bonds issued by state and local governments, is invalid under the doctrine of intergovernmental tax immunity.

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SECRETARY OF THE TREASURY

ON THE REPORT OF THE SPECIAL MASTER

BRIEF FOR THE DEFENDANT

JURISDICTION

The motion for leave to file a bill of complaint was granted on February 22, 1984. *South Carolina* v. *Regan*, 465 U.S. 367. The Special Master was appointed on April 23, 1984. *South Carolina* v. *Regan*, 466 U.S. 948. The Special Master's Report was received on February 23, 1987. The jurisdiction of this Court is invoked under Article III, Section 2 of the Constitution and 28 U.S.C. 1251(b).

STATUTE INVOLVED

Section 310 of the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 595-600 (originally codified at 31 U.S.C. 3121(g) and 26 U.S.C. 103(j), 163(f), 165(j), 312(m), 1232(c) and 4701), is set out as an appendix to this brief.

STATEMENT

Plaintiffs in this original action challenge the constitutionality of Section 310(b)(1) of the Tax Equity and

Fiscal Responsibility Act of 1982 (TEFRA), Pub. L. No. 97-248, 96 Stat. 596. That section provides that the federal income tax exemption for interest paid on publicly-offered long-term debt obligations [1] issued by state and local governments extends only to interest paid on bonds issued in registered form. The Court appointed a Special Master to develop a record, and he conducted hearings and took evidence over three weeks in November 1985 and January 1986. The Court received the Special Master's Report [hereinafter Report] on February 23, 1987, and set a schedule for the filing of exceptions and briefs. We have not filed any exceptions to the Report; plaintiffs South Carolina and the National Governors' Association,[2] on the other hand, did file exceptions with supporting briefs. We begin our response to those exceptions by summarizing the Special Master's recommended findings of fact and conclusions of law.[3]

1. *The Municipal Bond Marketplace.* The Special Master found that there are "approximately 47,000 issuers of municipal obligations" and that such issuers "range in size from large States and public agencies to small school and sewer districts" (Report 20). The quantity of municipal bonds [4] has increased rapidly in

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[1] For purposes of simplicity, we will hereafter refer to publicly-offered long-term debt obligations simply as "bonds."

[2] On June 22, 1984, the NGA moved to intervene as plaintiff, and this Court referred the motion to the Special Master (468 U.S. 1226). He recommended that the motion be granted with the proviso that the NGA satisfy certain conditions designed to prevent delay and duplication of proof. Report of Special Master (Nov. 16, 1984). In his final Report (at 3-4 & n.7), the Master concluded that the NGA had met these conditions. Although we opposed the NGA's intervention before the Special Master, we are not renewing that argument here.

[3] Amicus briefs supporting plaintiffs were filed by Pennsylvania and 22 other States [hereinafter Pennsylvania Br.]; the Public Securities Association [hereinafter PSA Br.]; and the Government Finance Officer Association [hereinafter "GFOA Br."].

[4] We use the term "municipal bonds" to refer to bonds issued by both state and local governments.

recent years, from $23 billion of new issues in 1974 to $102 billion in 1984. The bulk of the dollar volume of such bonds is concentrated in relatively few large issues: 83% of the dollar volume of municipal bonds issued in 1983 was taken up by issues of $10 million or more. The majority of bond issues, on the other hand—76% in 1983—consists of issues of less than $10 million. Report 20-21.[5]

The Special Master found that "[t]he principal investors in municipal securities are commercial banks, casualty insurance companies and individuals" (Report 21). Banks and insurance companies hold approximately 57%-58% of all outstanding municipal securities. The remaining bonds are owned by individuals, and approximately three-quarters of those are held indirectly through mutual funds or bank trust departments. Thus, individuals directly hold only about 10%-12% of all municipal bonds. *Id.* at 22.

Bonds historically have been issued in one of two forms—registered bonds or bearer bonds. The Special Master observed (Report 24) that "[b]earer bonds are characterized by their extreme ease of transfer. They are presumed by law to be owned by the holder, and are negotiated by simple transfer of physical possession." "The central characteristic of a registered bond," on the other hand, "is the existence of a list, or lists, on which ownership of the bond is recorded" (*ibid.*).[6] A change

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[5] Municipal debt obligations are divided into two general categories: (1) general obligation bonds, which are "backed by the full faith and credit (and the taxing power) of the borrowing government"; and (2) revenue bonds, which are "backed entirely by the revenue produced from some particular facility or activity, usually the revenue of the enterprise funded by the bond issue," such as a hospital or toll road (Report 22). The proceeds of one form of revenue bond—industrial development bonds—are used by a government entity to assist "the trade or business of a private person" (*id.* at 23). These bonds generally are issued by governments desirous of promoting industrial expansion (*ibid.*).

[6] The Special Master observed (Report 25) that "registration can take several forms. Registered bonds can be issued in a certifi-

in the record owner of a registered bond can be effected only by a change in the ownership list maintained by the bond's transfer agent. In some situations, the record owner of a registered bond may differ from the beneficial owner, as where a broker holds a bond in "street name" on behalf of a client, or where a mutual fund holds bonds beneficially owned by its shareholders (*id.* at 26).

Two distinctions between bearer bonds and registered bonds were highlighted by the Special Master. First, the mechanics of interest and principal payments differ. Interest payments on bearer bonds are obtained by the presentation of a bond coupon. The bondholder typically presents the coupon to a bank, which often "charges [him] a fee ranging from $3 to $7 per coupon" for processing it (Report 27). The bank then forwards the coupon to the financial institution designated by the issuer as its "paying agent." The "paying agent" inspects the coupon for authenticity and directs payment to the bank. A similar procedure is used for payment of principal at maturity. *Id.* at 24, 27. In the case of registered bonds, by contrast, payments of interest and principal "are made automatically by check or electronic transfer of funds. These alternatives are available because record owners are always ascertainable. * * * [This] eliminates the need to process coupons" (*id.* at 27).

Second, registered bonds are more easily handled by securities depositories than are bearer bonds. The Special Master explained (Report 28) that "[s]ecurities depositories were established in the late 1960's and early 1970's to reduce the increasing expense associated with physical handling of securities. Prior to the advent of depositories, settlement of bond transactions involved

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cated form where the debt obligations are evidenced by physical certificates. Registered bonds may also be issued and held in book entry form, which eliminates all but one 'global' certificate. * * * In the pure book entry form, all transfers occur by book entry and investors cannot receive a physical certificate evidencing their ownership."

physical transportation of securities from the seller to the buyer through their respective brokers." Under the depository system, by contrast, "[t]he transfer takes place by computerized entries in the records of the depository rather than by any physical movement of securities" (*id.* at 29). The Special Master found (*id.* at 32) that these automated systems involving immobilization and book entry:

> function more efficiently with registered as opposed to bearer securities. The systems function better because registered bonds do not require physical storage and processing of large volumes of certificates and coupons. Although depositories can handle bearer securities, they are hampered by the storage, security, insurance and coupon clipping functions bearer bonds require.

Indeed, it was largely because of these efficiencies that most large corporations, long before TEFRA was enacted, voluntarily shifted from bearer-form to registered-form bonds (Tr. 1245-1250, 1255-1257).

2. *Congress's Adoption of Section 310.* Spurred by a mounting federal budget deficit, Congress in 1982 considered a range of revenue enhancement measures. Studies conducted by the IRS had revealed that substantial revenues could be obtained through better tax enforcement. The studies estimated that unreported income from legal activities had risen from $29.3 billion in 1973 to $87.2 billion in 1981; that unreported capital-gain income had increased fourfold over the same period; and that income from illegal activity had also grown substantially. Report 11-12.

Congress in 1982 adopted TEFRA, which contains a variety of provisions designed to promote compliance with the tax laws. One of these provisions is Section 310, which establishes strong incentives for the issuance of bonds in registered, rather than bearer, form. Thus, Section 310(a) provides that "registration-required" [7]

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[7] Although the term "registration-required" is defined somewhat differently in various provisions of Section 310, it generally refers

obligations of the United States or of any agency or instrumentality thereof must be issued in registered form. Similarly, Section 310(b)(2) and (3) deny private corporations a tax deduction, as well as an adjustment to their earnings-and-profits accounts, with respect to interest paid on "registration-required" corporate bonds not issued in registered form.[8]

Section 310(b)(1) completes this statutory scheme by amending Section 103 of the Code, which generally exempts from federal income tax the interest received by owners of municipal bonds.[9] Under the amended provision, the tax exemption does not extend to interest paid on "registration-required" obligations unless the obligations are issued in registered form.

The Special Master's Report (at 12-19) summarizes the legislative history of Section 310. The Treasury Department's initial proposal regarding incentives for the issuance of municipal bonds in registered form related exclusively to one type of bond—industrial development bonds (IDBs). Under that proposal, the tax exemption for interest on IDBs would have been limited to bonds that were in registered form and that satisfied certain

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to any debt instrument with a maturity of one year or more that is offered for sale to the public.

[8] In addition, Section 310(b)(4) subjects unregistered corporate obligations to an excise tax; and Section 310(b)(5) and (b)(6) provides that holders of unregistered corporate obligations are not entitled either to deductions for their losses or to capital-gain treatment for their gains.

[9] Section 103 of the Internal Revenue Code of 1954 (I.R.C. or the Code) has been recodified as various sections of the Internal Revenue Code of 1986. See Tax Reform Act of 1986, Pub. L. No. 99-514, § 1301, 100 Stat. 2602. Section 310(b)(1) of TEFRA, the provision at issue here, was originally codified as Section 103(j) of the 1954 Code, and is recodified without substantial change in Section 149(a) of the 1986 Code. See Tax Reform Act of 1986, § 1301(b). The Special Master's Report, however, refers to the provisions of the 1954 Code, and for purposes of clarity and consistency we will generally do the same.

conditions upon the use of the borrowed funds. Representatives of state and local governments discussed this proposal with Treasury Department officials and testified about it before Congress. Report 12-13. Their testimony addressed the registration requirement and "Congress was clearly apprised of the arguments against registration" (*id.* at 14).

Representative Rostenkowski subsequently proposed incentives for the issuance of virtually *all* bonds—those issued by the United States and private corporations as well as by state and local governments—in registered form. This proposal was eventually embodied in Section 310 of TEFRA. The reasons for its adoption were set forth in the Senate report (1 S. Rep. 97-494, 97th Cong., 2d Sess. 242 (1982)):

> The committee believes that a fair and efficient system of information reporting and withholding cannot be achieved with respect to interest-bearing obligations as long as a significant volume of long-term bearer instruments is issued. A system of book-entry registration will preserve the liquidity of obligations while requiring the creation of ownership records that can produce useful information reports with respect to both the payment of interest and the sale of obligations prior to maturity through brokers. Furthermore, registration will reduce the ability of noncompliant taxpayers to conceal income and property from the reach of the income, estate, and gift taxes. Finally, the registration requirement may reduce the volume of readily negotiable substitutes for cash available to persons engaged in illegal activities.

3. *The Special Master's Findings Regarding the Burdens and Benefits That Flow From Section 310(b).* The Special Master concluded that "[b]y eliminating the tax exempt status of municipal bonds in bearer form, Section 310(b)(1) * * * effectively requires state and local governments to issue their debt in registered form" (Report 23). Before the provision took effect "almost all

municipal bonds were issued in bearer form"; following the statute's effective date, "no state or local government has issued debt in other than registered form" (*id.* at 23-24). The trial before the Special Master centered upon "the actual impact of TEFRA's registration requirement upon States and localities" and "whether there is an overriding public interest in requiring municipal bond registration" (*id.* at 34, 80). The Special Master concluded that "[t]he burdens of establishing and maintaining a system of registered municipal bonds do not weigh heavily upon the States" and that "registered bonds are helpful to tax enforcement authorities in their collection efforts" (*id.* at 88, 191).

a. With respect to the statute's effect on state and local governments, the Special Master found that, as a general matter, registration "affects the form of state and local debt issues, but does not reach the substance of state and local borrowing. The requirement does not appear to affect either the States' ability to borrow or the States' relative use of their various sources of funds (*e.g.*, borrowing, taxes and federal grants)." Report 35. He further concluded that "the form of municipal bonds —registered versus bearer—is a matter of little intrinsic significance to states and localities" (*ibid.*).

Plaintiffs' claims about the burdens allegedly imposed by Section 310(b) fell into four basic categories. They first argued that States and localities incurred additional costs because they had to amend statutes and alter administrative procedures in order to issue registered bonds. The Special Master observed that "[t]he time and money expended to comply with TEFRA, both at the legislative and administrative levels, was not insignificant" (Report 36). But he concluded that "the evidence taken as a whole indicates that the expenditures were not so great nor the activities so qualitatively different from those ordinarily required of state legislative and executive officials so as to detract from the accomplishment of the ordinary tasks of state and local government. The effort required to comply with TEFRA did

not prevent [those] governments from accomplishing other priorities" (*ibid.*).

Second, plaintiffs argued that the transaction costs incurred in connection with bond issues increase when bonds are issued in registered form. The Special Master found that "[o]riginal issuance costs," such as printing, bond counsel fees, and other such costs, "are not significantly different for registered and bearer bonds" (Report 41). As to ongoing administrative costs, such as fees charged to an issuer in connection with interest payments, the Special Master found that there were some cost differences. For large issues—those of $25 million or more, which comprise the bulk of the municipal bond market by dollar volume—administrative costs are *lower* for registered bonds. For medium-sized issues—those between $10 and $25 million—there is hardly any difference in such costs. For smaller issues—those of less than $10 million, which comprise only 17% of the market by dollar volume—administrative costs are slightly higher for registered bonds. For example, the Master found that "the cost difference per million dollars for a $1 million bond issue is approximately $3,300 in favor of bearer bonds over the assumed twenty year life of the issue." *Id.* at 42. That would work out to $165 per year.

Third, the Master evaluated plaintiffs' central contention regarding the economic burdens allegedly imposed by Section 310(b)—that the interest-rate cost to the issuer of a registered bond is higher than the cost for a comparable bearer bond.[10] The Master found that this claim necessarily rested on two premises: "(1) investors prefer bearer bonds over registered bonds such that (2) investors will extract an interest rate penalty or 'premium' for state and local debt issued in registered form"

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[10] In its complaint (Exh. B, para. 8), South Carolina had asserted that this supposed interest-rate differential was 25 basis points (0.25%). At trial, however, plaintiffs reduced their claim, asserting that the differential was between 5 and 15 basis points (Report 45).

(Report 45). The Master found both premises insupportable.

As to the first premise, the Master observed that "large institutional investors hold the majority of outstanding municipal bonds" and that "[t]hese institutions have no preference to handle bearer bond certificates and clip coupons" (Report 47). In the case of individual investors, the Master refused to accept plaintiffs' image of "an older, wealthy individual * * * who cherishes the familiarity of the bearer system" and who would therefore demand a higher interest rate before agreeing to purchase a registered bond (*ibid.*). Rather, because "the handling of bearer securities is demonstrably more expensive and inconvenient for an investor than the handling of registered securities," he found it unlikely that individuals would have "a preference of sufficient strength to create an interest rate differential" (*ibid.*). Indeed, as the Master noted, most individuals do not take physical possession of the bonds they own—and hence do not care what form the bonds are in—because their investments increasingly are mediated by institutions like mutual funds, bank trust departments, and unit investment trusts (*ibid.*). In sum, "[t]he record does not support any strong or consistent investor preference for bearer municipal bonds"; instead, the dominance of bearer bonds in the municipal market prior to the enactment of Section 310(b) "appears to have been due not to investor preference, but to the absence of an impetus or motivation to change." Report 47, 48.

As to the second premise of plaintiffs' argument—that investors have acted on their supposed preference for bearer bonds by exacting an interest-rate penalty from issuers of registered bonds—the Master found that the testimony of several market participants, whose views constitute "an excellent guide to actual investor preferences and market demand," flatly contradicted plaintiffs' position (Report 53). In particular, the Master cited the testimony of one witness, employed by a major municipal bond underwriter, who stated that, with the pos-

sible exception of certain Florida issues, there was "no evidence of any yield differential between registered and bearer form * * * anywhere in the market" (*id.* at 51). This witness indicated that bond traders do not inquire about the form of a municipal bond prior to sale, and do not differentiate between bond forms when making a bid. Other municipal bond specialists provided similar testimony. *Id.* at 51-53. The Special Master concluded that the testimony of these market participants "undermines the foundation for plaintiff's interest rate contention" because "[n]either investors nor traders exact such a penalty" on registered bonds (*id.* at 54).

The Special Master noted that the parties placed considerable emphasis upon statistical evidence designed to prove or disprove the existence of an interest-rate differential. He painstakingly evaluated the parties' statistical studies (Report 54-76), but concluded that "[e]ach of the econometric studies rested on assumptions that ultimately proved unreliable and unsupported. The studies attempted to measure a very small and perhaps ephemeral effect with highly imprecise data and tools that proved too blunt for the task. Ultimately the various studies * * * do not provide an unequivocal or definitive answer to the question whether the registration requirement resulted in an interest rate penalty for municipal issuers" (*id.* at 76-77).

Plaintiffs' fourth and last contention regarding the costs allegedly imposed by Section 310(b) was that it effected "a diminution of the sovereign status of the States" (Report 77). The Master recognized that the power to raise funds is "essential to the States' ability to exercise sovereignty within the federal system," but found that the statute had no effect on their ability to borrow funds or on their fiscal condition in general. Although Section 310(b) "did change the form in which state debt is issued," the Master concluded that "the decision to issue debt in one form or another is essentially a practical one: it is tied to the issuer's perception of the desires of the marketplace. The totality of the

record indicates that, prior to TEFRA, the States did not attach any special importance to the form in which their bonds were issued" (*id.* at 77-78).[11]

[11] The Special Master also observed that "[p]rior to TEFRA, the United States had taken steps to restrict the issuance of tax-exempt state and local government debt securities" (Report 8). In 1980, Congress had required that several species of municipal bonds be issued in registered form as a condition to their tax-exempt status (*id.* at 9-11). Even earlier, the Internal Revenue Code had established an exhaustive set of extremely complicated criteria with which the States must comply if they wish to secure tax exemption for the interest paid on bonds issued for other than strictly governmental purposes, such as "industrial development bonds" and "mortgage subsidy bonds." See I.R.C. §§ 103(b)(1) through (18), 103(c)(1) through (7) and 103A(a) through (o). These provisions regulate both the amount of bonds that the States are permitted to issue and the uses to which the proceeds of the bonds may be put. These provisions apply to such diverse obligations as "qualified scholarship funding bonds" (I.R.C. § 103(e)), "obligations of certain volunteer fire departments" (I.R.C. § 103(i)), "consumer loan bonds" (I.R.C. § 103(o)(2)), "qualified student loan bonds" (I.R.C. § 103(o)(3)), and bonds used to fund rental housing projects (I.R.C. § 103(b)(4)(A) and (12)), sports facilities (I.R.C. § 103(b)(4)(B)), convention facilities (I.R.C. § 103(b)(4)(C)), airports and parking facilities (I.R.C. § 103(b)(4)(D)), pollution control facilities (I.R.C. § 103(b)(4)(F) and (11)), hydroelectric generating facilities (I.R.C. § 103(b)(4)(H) and (8)), "qualified mass commuting vehicles" (I.R.C. § 103(b)(4)(I) and (9)), "local district heating and cooling facilities" (I.R.C. § 103(b)(4)(J) and (10)), and "facilities for the furnishing of water for any purpose" (I.R.C. § 103(b)(4)(G)). State and local governments are required to refrain from issuing "arbitrage bonds" (I.R.C. § 103(c)(1), (2) and (3)); they are required to comply with elaborate information reporting requirements concerning their industrial development bonds (I.R.C. § 103(*l*)); they are required to comply with strict limitations on the aggregate amount of "private activity bonds" issued during any calendar year (I.R.C. § 103(m)); and they are required to obtain "public approval," often in the form of a "voter referendum," for each industrial development bond that they issue (I.R.C. § 103(k)(2)(A) and (B)(ii)). Even more substantial regulatory requirements on the issuance of state and local bonds were enacted by Congress in the Tax Reform Act of 1986, Pub. L. No. 99-514, §§ 1301-1318, 100 Stat. 2602-2711. The inducement for compliance with all of these regulatory requirements, like the inducement for compliance with the TEFRA regis-

b. Turning to the benefits flowing to the federal government from Section 310(b), the Master rejected plaintiffs' contention that bearer municipal bonds are unrelated to the problem of tax noncompliance and that Section 310(b) therefore does not further any public interest. He found (Report 84) that

> the fundamental attributes of bearer bonds are enormously helpful to individuals desiring to evade the tax laws and to conceal unreported income. Bearer bonds are convenient to transport and hide, are easily negotiable at published prices, involve anonymity and minimal reporting requirements, and are capable of supporting substantial amounts of cash. Moreover, bearer municipal bonds—unlike other cash substitutes—earn interest, and tax-exempt interest at that.

The Master noted that bearer municipal bonds had been found to be an important element of many tax avoidance schemes (*id.* at 86-87). "Given the inherent characteristics of bearer bonds," he stated, "Congress's conclusions that they facilitate tax avoidance and income concealment seem altogether reasonable" (*id.* at 84).

The Master further concluded that the registration of municipal bonds provides significant assistance to tax collection efforts. It "create[s] an audit trail which * * * enable[s] tax authorities to trace the ownership of municipal bonds for estate and gift tax purposes" (Report 85). In addition, registration helps to foil capital gains tax evasion and income concealment because "[r]egistered securities * * * provide some additional information concerning when changes in ownership occurred" (*id.* at 88). Thus, although the registration system is not tamperproof, "registered bonds are helpful to tax enforcement authorities in their collection efforts" (*ibid.*).

4. *The Special Master's Legal Conclusions.* After setting forth his recommended factual findings, the Master

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tration requirement, is the threatened loss of tax exemption on the interest paid on the bonds. Compare I.R.C. §§ 103(a)(1), (b)(1) and (c)(1) and 103A(a) with § 103(j).

turned to a discussion of the legal principles governing plaintiffs' claims.

a. The Master first considered whether the registration provision exceeds "the affirmative limits that our constitutional structure places upon the ability of Congress to exercise its delegated, enumerated powers to affect the States and their political subdivisions" (Report 89). The Master noted that this Court's decision in *Garcia* v. *San Antonio Metropolitan Transit Authority*, 469 U.S. 528 (1985), overruling *National League of Cities* v. *Usery*, 426 U.S. 833 (1976), "altered the landscape of federalism jurisprudence, but left the judicial mapping of the new terrain of federalism to future cases." He concluded, however, that "the facts established during the hearing indicate that adjudication of the federalism questions presented here does not * * * require an extensive probe of uncharted areas. Under well established principles, TEFRA's registration requirement is a permissible exercise of federal regulatory power over the States" (Report 117).

The Master evaluated each of plaintiffs' contentions regarding the costs allegedly imposed by Section 310(b) to determine whether those costs had any effect upon the States' autonomy and independence. He first concluded that the alleged "administrative and legislative transition costs" were irrelevant because plaintiffs had not shown that those costs "detracted from the States' ability to perform any significant governmental functions, much less from achieving critical priorities" (Report 128). The Master next concluded that plaintiffs' position was not aided by the alleged (but unproven) interest-rate differential or by marginal increases in some transaction costs. "Problems of proof aside," the Master stated, "these burdens are purely financial in nature" (*id.* at 130). Such costs are not "legally cognizable" because "[o]f themselves, increased costs traceable to federal regulation are insufficient to establish a threat to state autonomy and independence" (*ibid.*).

The Special Master also rejected plaintiffs' claim that "the 'sovereignty costs' of the registration requirement

are so great as to offend principles of constitutional federalism" (Report 123). Plaintiffs' argument was that Section 310(b) "invades a uniquely and peculiarly sovereign function—the raising of revenue—and does so without achieving its intended national purpose of facilitating federal tax compliance" (Report 123). The Master rejected both prongs of that argument, finding that registration was reasonably designed to promote tax compliance[12] and that it had no perceptible impact on state sovereignty.

"Plaintiffs acknowledge[d] that their ability to borrow by selling bonds continue[d] undiminished * * * after passage of TEFRA," the Master noted, and he found "no suggestion that control over the form of their bonds was of any intrinsic significance to the States." "Control over municipal bond form," he concluded, "has none of the symbolic resonance for state autonomy that, for example, controlling the location of the state capital has." Report 124 (citing *Coyle* v. *Smith*, 221 U.S. 559 (1911)). Since "[a]bsent the federal registration requirement, States would choose the form of their bonds solely according to considerations of efficiency and market demand," the Special Master found no improper intrusion on the States' autonomy "[e]ven under a *National League of Cities* level of scrutiny" (Report 124).

Finally, the Special Master noted that this Court's decision in *Garcia* "suggests that judicial review must be attuned to possible failings in the national political process" (Report 133). Here, "[t]he clarity of Congress's intent to regulate the States, the political history of prior substantive congressional regulation of municipal bond issuance, and the breadth of application of the TEFRA

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[12] The Master declined to second-guess Congress's judgment that the registration provision furthers an important federal interest: "the judiciary is not empowered to undertake a free wheeling inquiry into the adequacy of the evidence before Congress or its political motives in passing legislation" (Report 125). That determination "'is ordinarily a matter committed to legislative judgment,'" and the Special Master found nothing in the record suggesting that "judicial review of Congress's factual predicate" was either "appropriate or required" (*id.* at 126 (citation omitted)).

registration requirement leave little room for an inference that [Section 310] is a product of the federal political process's failure to heed or safeguard vital state interests" (*id.* at 139). The Master accordingly concluded that the enactment of Section 310(b) did not imply a defect in the political process; to the contrary, the "general structural features of the legislation" instead showed that "the political process [had] performed as intended" (*id.* at 140).

b. The Master next turned to plaintiffs' claim that Section 310(b) violates the doctrine of intergovernmental tax immunity. He first noted that the issue in this case is not whether Congress may completely eliminate the tax exemption for interest on municipal bonds. "The more narrow issue presented," rather, "is whether the intergovernmental tax immunity doctrine requires Congress to maintain the exemption for municipal bond interest intact and sacrosanct—regardless of the burden (or lack thereof) imposed upon the States by the use, as a regulatory incentive, of the threatened loss of that exemption" (Report 143).

Following a comprehensive analysis of this Court's decisions concerning the intergovernmental tax immunity doctrine (Report 144-180), the Master summarized the modern contours of that doctrine, and the obstacles facing plaintiffs thereunder, as follows (*id.* at 181):

> To prevail on their claim that the tax sanction violates the States' constitutional tax immunity, plaintiffs must show that the sanction operates to discriminate against the States. Failing that, plaintiffs might still prevail if they could demonstrate that the actual impact of the sanction threatens the continued existence of the States or interferes unduly with their ability to perform essential government functions.

He concluded that plaintiffs had made neither of these showings.

The Master first pointed out that the registration provision does not discriminate against the States because "Congress applied [it] to all issuers of debt obligations"

(Report 182). Separate provisions of TEFRA, he noted, require the United States to issue its bonds in registered form, and provide private corporations with strong incentives to do the same; the latter incentives, moreover, are analogous to and, indeed, more onerous than the incentives that operate on municipal issuers (*ibid.*). And far from posing "a danger to the States' continued existence," the challenged statute, the Master had previously found, imposed no appreciable burdens on the States at all (*id.* at 181-182).

Finally, the Special Master rejected plaintiffs' reliance on *Pollock* v. *Farmers Loan and Trust Co.*, 157 U.S. 429 (1895), in which this Court held that the federal government may not tax the interest income received on municipal bonds. The *holding* of that case, he noted, is not at issue here because Congress in 1982 did not purport to repeal the tax exemption for municipal bond interest. Although plaintiffs also sought to deduce from *Pollock* a broader rationale to support their contention that the interest exemption must remain absolute and unqualified, the Master found their effort unsuccessful. The reasoning of that 1895 decision, he explained, had been expressly renounced by this Court during its substantial reshaping of the tax immunity doctrine in the intervening 92 years. "[S]ince tax immunity for [municipal bond interest] cannot be regarded as abstract and complete, as it was when *Pollock* was decided, the States are required to show that the tax sanction was discriminatory or destructive of their independent existence. They have not carried that burden." Report 184.[13]

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[13] The Special Master rejected two other contentions advanced by plaintiffs. First, he found that the economic costs of complying with Section 310 did not constitute a "tax" upon the States. "If the compliance costs of TEFRA are viewed as a direct tax upon the States," the Special Master stated, "then any number of federal regulatory statutes that impose such costs upon the States must be viewed as tax measures. The Supreme Court has never viewed the costs of statutory compliance or the regulatory statutes themselves in that light" (Report 185). Thus, "[a]s long as these costs do not rise to a level that threatens the States' separate and

INTRODUCTION AND SUMMARY OF ARGUMENT

The principle of federalism embodied in the Constitution defines "a system in which there is sensitivity to the legitimate interests of both State and National Governments, and in which the National Government, anxious though it may be to vindicate and protect federal rights and federal interests, always endeavors to do so in ways that will not unduly interfere with the legitimate activities of the States" (*Younger* v. *Harris*, 401 U.S. 37, 44 (1971)). Implementing the federalism principle in particular cases is often difficult and complex, as this Court's decisions show. See, *e.g.*, *Garcia* v. *San Antonio Metropolitan Transit Authority*, 469 U.S. 528 (1985), overruling *National League of Cities* v. *Usery*, 426 U.S. 833 (1976); *FERC* v. *Mississippi*, 456 U.S. 742 (1982). Plaintiffs suggest that the instant case raises similar questions of great moment as to the appropriate relationship between the States and the federal government. Plaintiffs are simply wrong.

What is actually at issue here is an insignificant, even trivial, condition on the broad exemption from federal income tax for the interest paid on municipal bonds. Congress in 1982 took numerous steps to bolster tax collection. Because evidence before Congress indicated that bearer bonds were often used to conceal income and evade taxes, Congress enacted the statute challenged here, which provides strong incentives for the issuance of *all* bonds—federal, corporate, and municipal—in regis-

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independent existence—and there has been no showing that they do [here]—there is no basis for considering them an impermissible direct tax upon the States" (*id.* at 186-187).

Second, the Special Master concluded that Section 310(b) does not impose an unconstitutional regulatory tax. He stated that "a tax that is purely regulatory in purpose and effect is not, for that reason alone, unconstitutional. The tax is invalid only if the regulatory goal sought to be fostered is otherwise beyond Congress's power" (Report 188-189). Since Section 310 can be sustained as an exercise of Congress's regulatory authority under the Commerce Clause or "as a necessary and proper means of protecting the national taxing power," the Special Master found it to be a permissible regulatory tax (*id.* at 190).

tered form. The particular incentive for issuers of municipal bonds is that only registered bonds qualify for the federal income tax exemption.

Plaintiffs raise two constitutional objections to this provision. First, they assert that it exceeds the Tenth Amendment limitations upon Congress's authority to regulate the States. Second, they contend that Section 310(b) violates the intergovernmental tax immunity doctrine. The Special Master painstakingly reviewed these claims in a 193-page Report whose thoughtfulness and thoroughness make this brief largely superfluous. He correctly found that, as a factual matter, plaintiffs had failed to present any evidence tending to show that Section 310(b) violates these constitutional principles.

ARGUMENT

I. THE SPECIAL MASTER'S RECOMMENDED FINDINGS OF FACT SHOULD BE ADOPTED BY THIS COURT

The Special Master's findings of fact fill more than 80 pages of his Report; each finding is amply supported by citations to the evidentiary record. We urge the Court to adopt those findings in full. See *Colorado* v. *New Mexico*, 467 U.S. 310, 317 (1984) (Special Master's factual findings "deserve respect and a tacit presumption of correctness").

Plaintiffs have filed half-hearted exceptions to a few of the Master's factual findings. The NGA contends (Br. ii-iii, 15), although it advances no argument to support its contention (see Br. 21-44), that the Master erred in finding that there is no interest-rate differential between comparable registered and bearer bonds. South Carolina has included a laundry list of exceptions in its brief, but it actually discusses only two: the Master's finding regarding the supposed interest-rate differential (Br. 11, 86-89), and his determinations about the administrative costs entailed by registered bonds (Br. 10, 82-85).[14] Nei-

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[14] Since South Carolina has failed to discuss the basis for its other exceptions, we simply submi. hat the Master's recommenda-

ther of these findings is critical to the Master's legal conclusions. See Report 123, 130-132. But both findings are plainly correct.

1. As to the supposed interest-rate differential, the Master emphasized that the ultimate inquiry is whether investors have such a strong preference for bearer bonds that they will extract a "premium" interest rate when purchasing registered bonds. He then evaluated the three categories of evidence submitted by the parties on this point: (1) evidence relating to the reasons why investors would (or would not) prefer bearer bonds; (2) evidence from market participants about the existence of an interest-rate differential; and (3) the parties' ill-fated statistical studies. He concluded that there was no evidence supporting the existence of an investor preference for bearer bonds and hence that plaintiffs had failed to carry their burden of proof. Report 46-77.

South Carolina first argues (Br. 87-89) that the record does contain some evidence of an investor preference for bearer bonds. The gist of the State's position is that the existence of such a preference may be inferred from the fact that most municipal bonds were issued in bearer form before 1982. But the Master found such an inference to be factually insupportable. Instead, he found that the municipal bond market before 1982 operated "by custom and without central direction. * * * The dominance of bearer securities appears to have been due not to investor preference, but to the absence of an impetus or motivation to change" (Report 48).[15]

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tions in those respects should be adopted on the basis of the analysis in his Report.

[15] Most corporate and Treasury securities had been shifted to registered form well before TEFRA was enacted, and municipal bonds were thus the only category of bonds that were still issued largely in bearer form at that time (Tr. 1211-1212, 1216, 1223-1226, 1245-1250, 1255-1257). The Special Master found (Report 32-33) that "[t]he municipal bond market in all probability would have moved to a registered book entry system on its own even if TEFRA had not been enacted. TEFRA merely hastened the trend toward automation."

More generally, the Master concluded that "[t]he record does not support any strong or consistent investor preference for bearer municipal bonds" (Report 47). He found that (1) the added expense and inconvenience associated with bearer bonds weighs against such a preference; (2) the entities that hold most municipal bonds—institutional investors and institutions that hold bonds for individuals' accounts—do not prefer bearer bonds, and (3) the only investors whom plaintiffs even claim to prefer bearer bonds—individual investors who take physical possession of the bonds that they purchase—comprise a very small proportion (about 10%-12%) of the market. "The indifference of so many investors to physical possession of their municipal bonds undermines plaintiffs' contention that there exists an investor preference for bearer bonds of sufficient strength and breadth to give rise to an interest rate differential" (*id.* at 48).

South Carolina next argues that the Special Master should have accepted the testimony of its Treasurer (testimony unsupported even by the NGA's experts) that registered bonds carry an interest-rate penalty of 0.25% over comparable bearer bonds (Br. 86). The Treasurer of South Carolina, however, could provide no basis for his assertion "other than conversations with market participants whom he could not name" (Report 49). The Special Master's disinclination to credit this testimony is amply supported by the record. The Treasurer of Delaware stated that, "based on her discussion with bond underwriters and others involved in public finance, * * * there was no interest rate differential on Delaware bonds" (Report 50). New Jersey's Assistant Treasurer reached the same conclusion, stating in a memorandum that "'[i]nvestors are not attaching a special economic value to the bearer obligation'" (*ibid.*).

Several municipal bond underwriters and dealers also testified: (a) that there is no interest-rate differential, (b) that traders do not inquire about the form of a bond when making a purchase or sale, and (c) that traders' price lists do not distinguish between registered and

bearer bonds (Report 49-53). The Special Master properly observed (*id.* at 53-54) that this testimony:

> is an excellent guide to actual investor preferences and market demand. Those who make their livelihood in the municipal bond markets will familiarize themselves thoroughly with customer preferences and underlying bond price determinants or soon be out of business. If the market imposed a penalty on registered bonds of sufficient size to be significant in the aggregate and over the long term, major market participants would know of the differential. Indeed, these participants would, at least in part, impose it.

Third, the NGA asserts (Br. 14-15), and South Carolina appears to argue (Br. 87), that the government's statistical study, adjusted to account for certain errors in matching pairs of registered and bearer bonds, proves the existence of an interest-rate differential. The Special Master rejected this contention, concluding that all of the parties' elaborately-detailed statistical studies were hopelessly flawed both in their premises and in their conclusions (Report 76-77). The Master further observed that, even if the statistical studies had indicated an interest-rate differential, it was "as likely as not a result of a preference for bearer bonds by tax evaders and those seeking to conceal proceeds of illegal activities in anonymous, interest bearing instruments" (*id.* at 131). Plaintiffs introduced no evidence to explain *why* investors would legitimately prefer bearer bonds, and "the evidence suggest[ed] that illegal users of those bonds [would be] the most likely source of any such preference" (*id.* at 132). We agree with the Special Master that "[i]t is surely no infringement of state autonomy or independence to deny the States any interest benefits that may accrue to them from unlawful investor use of or demand for their bearer debt securities" (*ibid.*).

2. South Carolina seems to contend (Br. 83-85) that the Special Master also erred in assessing the administrative costs associated with the issuance of registered bonds. The Master divided such costs into two categories. With respect to the costs of originating a bond issue, he found

no difference as between bearer bonds and registered bonds. Ongoing administrative costs, on the other hand, did differ: registered bonds produced slightly *lower* administrative costs for large issuers and slightly *higher* costs for small issuers. Report 40-44.

The precise nature of South Carolina's challenge to these findings is not at all clear. The State may mean to argue that the Master underestimated the costs of issuing registered bonds, and it appears to proffer the alleged average cost of its own bond issues to support that position (see Br. 85). But the Master's conclusions on this point were based upon a report, prepared jointly by experts from both sides, that "effectively resolved factual disputes regarding this issue" (Report 40). Moreover, evidence at trial showed that the administrative costs associated with registered bonds issued by South Carolina just before the trial were substantially *lower* than they would have been had the bonds been in bearer form (Tr. 469-470, 2150), an experience shared by New Jersey and Michigan (Tr. 279-290, 322, 758, 797, 2151, 2155; DX 31).

II. SECTION 310(b) DOES NOT VIOLATE THE CONSTITUTION

Plaintiffs have raised two distinct constitutional challenges to Section 310(b). The complaint initially filed by South Carolina (at paras. 4, 7), and the complaint in intervention filed by the NGA (at para. IX), asserted that Section 310(b) exceeded the Tenth Amendment limitations upon Congress's authority discussed in *National League of Cities* and its progeny. When this Court in *Garcia* overruled *National League of Cities*, plaintiffs altered their argument, contending that Section 310(b) could not withstand scrutiny under the standard set forth in *Garcia*. In addition, plaintiffs have asserted that Section 310(b) is invalid for the separate reason that it violates the intergovernmental tax immunity doctrine.

Although plaintiffs now disagree among themselves about which doctrine—Tenth Amendment immunity or tax immunity— provides the proper framework for anal-

ysis, the selection makes little practical difference. The outcome of the constitutional inquiry is the same in either event. The Special Master observed that "[a]lthough the doctrine of limits on Congress's delegated powers flowing from state sovereignty and the doctrine of intergovernmental tax immunity have developed separately, they have a common source. Their source is the Constitution's recognition of the separate and independent existence of the States" (Report 90). Not surprisingly, therefore, analysis under the two doctrines turns upon similar factors—basically an examination of the burden imposed upon the States by the federal enactment. See *id.* at 112-113, 181. The Special Master correctly determined that Section 310(b) easily falls within the limitations that these two doctrines place on Congress's power.

A. Section 310(b) Does Not Exceed The Limits Upon Congress's Regulatory Authority Grounded In The Tenth Amendment And Principles Of Federalism

Section 310(b) is perhaps most conveniently analyzed under the Tenth Amendment principles that this Court has used to evaluate federal statutes that regulate the States. The instant statute, of course, is not literally cast as a regulation; instead, it gives state and local governments the choice of issuing tax-exempt bonds in registered form or issuing taxable bonds in bearer form, and municipal issuers have unanimously chosen the former alternative. But if Congress would have the power simply to require the States to issue *all* their bonds in registered form—banning bearer bonds from the national marketplace altogether—Congress certainly could take the lesser step of allowing the States the option of continuing to issue such bonds, but conditioning that option upon surrender of the tax-exempt feature. See *FERC* v. *Mississippi*, 456 U.S. at 765-767 (because Congress could preempt state regulation through the exercise of its Commerce Clause authority, it could condition continued regulation by a State upon the State's willingness to consider adopting federal standards); cf. *South Dakota* v. *Dole*, No. 86-260 (June 23, 1987). If the Tenth Amend-

ment would not prevent Congress from directly regulating the form of municipal bonds, in other words, it follows a fortiori that the Tenth Amendment does not prevent Congress from encouraging the States to adopt a particular bond form by means of a tax incentive. For purposes of Tenth Amendment analysis, therefore, Section 310(b) must be upheld as a permissible exercise of federal authority if Congress could constitutionally have required the States, in common with all other bond issuers, not to issue bearer bonds.

It cannot seriously be disputed that Congress has the authority to bar private entities from issuing bearer bonds in interstate commerce. See Report 127-128, 190-191. Such a bar would represent a valid exercise of Congress's Commerce Power and a valid regulation in aid of Congress's Taxing Power. The question here is whether a decision by Congress to extend such a regulatory bar to include *municipal* bearer bonds would transgress some limit imposed by the Tenth Amendment on Congress's authority under the Commerce Clause or the Taxing Clause.[16]

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[16] This Court has never addressed whether the Tenth Amendment restricts Congress's regulatory authority under the Taxing Clause. In *National League of Cities*, 426 U.S. at 852 n.17, the Court cautioned that the standard against which it measured statutes enacted under the Commerce Clause might not apply to statutes enacted under other provisions of the Constitution. Indeed, Justice Stevens observed in his dissenting opinion at the complaint stage of the present case (465 U.S. at 418) that "Article I, § 8 specifically delegates to Congress the 'Power to lay and collect Taxes,' and the Sixteenth Amendment removes any possible ambiguity concerning the scope of the power exercised by Congress." "[B]ecause the power to tax private income has been expressly delegated to Congress," Justice Stevens concluded, "the Tenth Amendment has no application to this case." The Court need not here determine, however, the precise relationship between the Tenth Amendment and the Taxing Power. Plaintiffs do not suggest that the Tenth Amendment limits, if any, that apply to the regulatory component of the Taxing Power would be *more stringent* than the limits that apply to the Commerce Power. Thus, if Congress could absolutely bar the issuance of municipal bearer bonds under the Commerce

Ascertaining the constitutional limits upon Congress's power to subject the States to federal regulatory authority has frequently proved to be a difficult task that has sharply divided this Court. But the Tenth Amendment issue here is neither difficult nor complex. We submit that a blanket prohibition by Congress on the States' issuance of bearer bonds would easily satisfy either the standard set forth in *Garcia* or the rule previously set forth in *National League of Cities*. The lesser restriction accomplished by Section 310(b)(1) is thus necessarily valid.

1. ***This Court's decision in* Garcia *is dispositive of plaintiffs' Tenth Amendment claim***

This Court concluded in *National League of Cities* that the Tenth Amendment imposed "an affirmative limitation" on Congress's power to legislate under the Commerce Clause (426 U.S. at 841). The Court there held that Congress could not constitutionally apply federal minimum-wage laws to the States because to do so "would directly impair their ability to structure integral operations in areas of traditional governmental functions." *EEOC* v. *Wyoming*, 460 U.S. 226, 237 (1983); *National League of Cities*, 426 U.S. at 852.

Nine years later, a closely-divided Court expressly overruled *National League of Cities* in *Garcia* v. *San Antonio Metropolitan Transit Authority*, *supra*. The Court in *Garcia* rejected as unworkable the "traditional governmental function" test, concluding that "[a]ny rule of state immunity that looks to the 'traditional,' 'integral,' or 'necessary' nature of governmental functions inevitably invites an unelected federal judiciary to make decisions about which state policies it favors and which ones it dislikes" (469 U.S. at 546). The Court found "no license to employ freestanding conceptions of state sovereignty when measuring congressional authority under the Commerce Clause" (*id.* at 550).

Power, it follows *a fortiori* that Congress can discourage the issuance of such bonds under the Taxing Power, as it has done in Section 310(b)(1).

The Court emphasized in *Garcia* that it "continue[d] to recognize that the States occupy a special and specific position in our constitutional system and that the scope of Congress's authority under the Commerce Clause must reflect that position" (469 U.S. at 556). The Court concluded, however, that "the principal and basic limit on the federal commerce power is that inherent in all congressional action—the built-in restraints that our system provides" through state participation in the national political process (*ibid.*) "The political process," the Court found, "ensures that laws that unduly burden the States will not be promulgated" (*ibid.*).

Although the Court in *Garcia* concluded that the political process is the primary safeguard for protecting the States' vital interests, it did not foreclose all judicial review to determine whether Congress in a particular case has impermissibly infringed state sovereignty. The Court found no need in the *Garcia* case "to identify or define what affirmative limits the constitutional structure might impose on federal action affecting the States under the Commerce Clause" (469 U.S. 556). However, in citing *Coyle* v. *Smith*, 221 U.S. 559 (1911), which had invalidated an attempt by Congress to condition Oklahoma's admission to the Union upon its agreement to establish its capital at a location of Congress's choosing, the Court suggested that extraordinary interferences with the structure of a state government would indeed be constitutionally impermissible. The Special Master thus correctly concluded (Report 117 n.394) that the *Garcia* opinion does not "abdicat[e] all judicial review of Commerce Clause legislation affecting the autonomy and independence of the States," but "merely suggests that the courts view the national political process with deference, and deploy the shield of the Constitution" only in "the extraordinary case."

While recognizing that *Garcia* "altered the landscape of federalism jurisprudence," the Master concluded that the instant case furnishes no occasion for "judicial mapping of the new terrain" (Report 117). Relying on the facts established at trial, the Master explicitly found that

Section 310(b) "would not have warranted judicial intervention even under the standards of *National League of Cities.*" He thus properly concluded that the statute's constitutionality "[u]nder the more deferential review of congressional power mandated by *Garcia* * * * seems beyond peradventure" (Report 192).

We adopt the Special Master's approach in addressing the Tenth Amendment issue. As we discuss below, there can be no doubt that plaintiffs' claim fails to satisfy the *National League of Cities* standard. Indeed, Justice Stevens aptly described plaintiffs' claim as "frivolous" at the time the Court granted leave to file the bill of complaint (465 U.S. at 418-419 & n.18). As in *Garcia* itself, therefore, the Court here need not "identify or define what affirmative limits the constitutional structure might impose on federal action affecting the States under the Commerce Clause" (469 U.S. at 556). Because Section 310(b) passes muster under *National League of Cities*, the statute *a fortiori* does not infringe the limits upon Congress's authority outlined in *Garcia.*

Before turning to the *National League of Cities* analysis, however, we pause briefly to address South Carolina's contention, based on *Garcia*, that Section 310(b) should be invalidated because "the political process failed to perform as intended" here (Br. 101). As we have noted, the Court stated in *Garcia* that the political process provides the "principal and basic" assurance that Congress will not intrude upon the States' prerogatives (469 U.S. at 556); the Court then said that "[i]n the factual setting of [*Garcia*] the internal safeguards of the political process performed as intended" (*ibid.*). South Carolina argues that the political process that led to the adoption of Section 310(b) did not satisfy the test that it believes the Court enunciated in *Garcia.*

To begin with, we doubt that plaintiff's proposed test is the one that the Court in *Garcia* contemplated. The Court surely did not mean that Tenth Amendment immunity should come and go, depending on an ad hoc, case-by-case evaluation of either (1) the quantum of the

States' input into the drafting and enactment of a particular federal law, or (2) the correctness of the substantive congressional findings underlying the decision to adopt a law. In noting that "[t]he political process *ensures* that laws that unduly burden the States will not be promulgated" (469 U.S. at 556 (emphasis added)), the Court's opinion suggests a *generic* reliance on the political process as an adequate safeguard for the States' legitimate concerns.[17] Indeed, this Court frequently has eschewed judicial inquiry into whether and to what extent a legislature on a particular occasion in fact heard and considered the views of particular competing parties. See, *e.g.*, *Schlesinger* v. *Reservists Comm. to Stop the War*, 418 U.S. 208, 221 n.10 (1974); cf. *United States* v. *O'Brien*, 391 U.S. 367, 383-384 (1968) (difficulties of inquiry into congressional motive).[18]

If some sort of particularized inquiry is called for, we think that the Special Master adopted a sensible approach. He examined "the general structural features of the legislation and the specific aspects of its implementation" to determine whether there was some unusual defect in the political process (Report 140). The Master correctly found that three separate characteristics of the legislative process leading to Section 310(b)'s enactment show that there was no such defect here.

First, the registration provision did not surface late in the legislative process so as to "sandbag" the States and

[17] The Court's reference to the States' participation in the federal legislative process is likewise an *institutional* point, as the Court's citations clearly show. See 469 U.S. at 551 n.11.

[18] The question whether the legislative process "performed as intended" in connection with the adoption of a duly enacted statute is a classic example of a political question that courts are ill-equipped to address. It is hard to see what standards—other than its own view regarding the proper functioning of the legislative process or the merits of the particular legislation—could possibly guide a court charged with making such an inquiry. And it is obvious that an Act of Congress cannot be invalid merely because it embodies a decision that differs from the views espoused by the States on a particular occasion.

prevent them from presenting their views to Congress. "Congress's early and explicit statement that it intended to pass legislation requiring registration of securities and affecting the States insured the States ample opportunity to resort to the political process to protect their vital interests" (Report 134).

Second, Section 310(b) was not the first federal statute that imposed conditions on the availability of a tax exemption for municipal bond interest. The Internal Revenue Code for many years had restricted the purposes for which tax-exempt bonds might be issued and, indeed, more recently had required that certain types of tax-exempt bonds be issued in registered form. See Report 8-11; pages 12-13 note 11, *supra*. The fact that the States had "accepted without challenge 15 years of far more intrusive congressional regulation of analogous aspects of their debt issuance functions," the Master explained, weighs strongly against South Carolina's argument that Section 310(b) "resulted from some extraordinary political process failure requiring judicial intervention" (Report 136-137).[19]

Finally, the Special Master observed that Congress in Section 310(b) did not single out the States, but also amended the law to require the United States, and to encourage private corporations, to issue only registered bonds. "[W]here Congress—in pursuit of a general regulatory objective—legislates universally and fails to exempt the States, it is * * * difficult to contend that the political process has failed to protect vital state interests" (Report 137). For these reasons, there is no basis for finding a defect in the legislative process that led to the adoption of Section 310(b).[20]

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[19] South Carolina asserts (Br. 106-108) that the Special Master erred in concluding that the States have acquiesced in these previous regulatory requirements, but it does not point to any evidence of prior challenges to them.

[20] South Carolina argues (Br. 95-105) that the political process failed because Congress assertedly made a mistake in analyzing the benefits that would inure to the federal government from

2. *Plaintiffs could not prevail under the* National League of Cities *balancing test*

The Tenth Amendment standard described in *National League of Cities* and its immediate progeny directed courts to evaluate several factors in considering whether a federal regulation impermissibly intrudes upon state autonomy. First, "there must be a showing that the challenged statute regulates the 'States as States.'" Second, "the federal regulation must address matters that are indisputably 'attribute[s] of state sovereignty.'" Third, "it must be apparent that the States' compliance with the federal law would directly impair their ability 'to structure integral operations in areas of traditional governmental functions.'" Fourth, the intrusion upon state autonomy must not be outweighed by the interest served by the federal statute. *Hodel* v. *Virginia Surface Mining & Reclamation Ass'n*, 452 U.S. 264, 287-288 & n.29 (1981) (citations omitted); see also *EEOC* v. *Wyoming*, 460 U.S. at 236-237; *United Transp. Union* v. *Long Island R.R.*, 455 U.S. 678, 684 & n.9 (1982); Report 104-105 & n.383.

Section 310(b)(1) is obviously directed against the "States as States." The statute also touches upon a subject—governmental borrowing for governmental purposes—that is an important attribute of state sovereignty. Report 124. Under a *National League of Cities* analysis, therefore, the questions here would concern the extent of the burden on the States and the significance of the benefits derived from the federal regulation.

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registration of municipal bonds. But this Court has made clear that it will not second-guess Congress's determinations regarding the efficacy of legislation. See, *e.g.*, *Hodel* v. *Virginia Surface Mining & Reclamation Ass'n*, 452 U.S. 264, 283 (1981); *Heart of Atlanta Motel, Inc.* v. *United States*, 379 U.S. 241, 262 (1964); Report 125-126. Nothing in *Garcia* suggests that this basic principle is somehow inoperative where the legislation affects the States. In any event, the Master correctly rejected South Carolina's contentions as a factual matter, finding that registration actually would provide significant assistance in tax collection. See Report 83-88.

a. The Special Master found it to be an undisputed fact that Section 310(b) "has not changed how much the States borrow, for what purposes they borrow, how they decide to borrow, or any other obviously important aspect of the borrowing process" (Report 118). Thus, the basic effect of the statute is that "States and localities (or their agents) must, in some form or another, maintain a list of the owners of their bonds" (*id.* at 119). Moreover, the Special Master found that "plaintiffs did not demonstrate any connection between the decision to issue bonds in bearer form and any aspect of state autonomy or independence." To the contrary, the record showed that the form of a bond, from the States' standpoint, was a mere "technical detail designed to facilitate bond sales and accommodate the desires of the market." *Id.* at 119-120.

These factual findings completely dispose of plaintiffs' Tenth Amendment claim. The inquiry under *National League of Cities* is whether the challenged federal statute has a "qualitative impact * * * upon the States' ability to choose the manner in which they would structure delivery of vital services." Report 121; see *EEOC* v. *Wyoming*, 460 U.S. at 240 (inquiry focuses on the "direct and obvious effect of the federal legislation on the ability of the States to allocate their resources"); *National League of Cities*, 426 U.S. at 847, 851-852 & n.17. The Special Master correctly concluded that because "municipal bond form does not affect the States' revenue raising function in any material way, and since bond form does not appear to be linked to any other important aspect of state governmental operations," Section 310(b) does not "threaten[] to impair state autonomy and integrity in any meaningful sense" and therefore does not implicate the Tenth Amendment. Report 120, 191-192; see also *South Carolina* v. *Regan*, 465 U.S. 367, 418-419 & n.18 (1984) (Stevens, J., dissenting) (characterizing plaintiffs' claim under *National League of Cities* as "frivolous").

Plaintiffs do not dispute the foregoing findings. South Carolina discusses in some detail (Br. 89-93) the importance of the States' ability to borrow money, but it simply ignores the Master's finding that Section 310(b) has had no effect on the States' ability to do so. Beyond this, South Carolina simply reiterates (Br. 80-89) its argument that the economic costs that it allegedly must incur in issuing registered bonds constitute a burden on state autonomy under *National League of Cities.* But the Special Master found as a factual matter that these costs are either small or nonexistent (Report 40-77, 120-133), and such speculative burdens cannot possibly suffice to establish "a threat to state autonomy and independence." *Id.* at 130; see *EEOC* v. *Wyoming*, 460 U.S. at 240-241; *FERC* v. *Mississippi*, 456 U.S. at 770 n.33; *Hodel*, 452 U.S. at 292; *National League of Cities*, 426 U.S. at 847, 851. South Carolina, in short, "made no effort to demonstrate" that the supposed cost increases, which had no effect on the States' ability "to perform any significant governmental function," had the sort of impact on state policy choices that is relevant under *National League of Cities.* Report at 128, 130-133 (discussing the complete absence of such evidence).

b. Even if Section 310(b) were found to impose on the States a burden cognizable under *National League of Cities*, the important interests underlying the federal statute would amply justify its virtually imperceptible intrusion upon state autonomy. Congress enacted Section 310(b) because it concluded that registration "reduce[s] the ability of noncompliant taxpayers to conceal income and property" and limits "the volume of readily negotiable substitutes for cash available to persons engaged in illegal activities" (1 S. Rep. 97-494, 97th Cong., 2d Sess. 242 (1982)). Simply put, bearer bonds are attractive to those who seek to evade the tax laws because they may be purchased and negotiated without recordation of the owner's identity. And, while carrying all the advantages that cash possesses, bearer bonds also pay interest. The

interest payments on *municipal* bearer bonds, moreover, are not reported to the Internal Revenue Service by the payor, thus eliminating (from the tax evader's point of view) a tell-tale sign that afflicts many other income-producing investments. Congress thus reasonably concluded that the elimination of bearer bonds, including municipal bearer bonds, would promote tax compliance.

The federal interest in enforcement of the tax laws is extremely weighty. See *United States* v. *Kimbell Foods, Inc.*, 440 U.S. 715, 734 (1979) ("[C]ollection of taxes is vital to the functioning, indeed existence, of government."). Under a *National League of Cities* approach, therefore, the federal interest, when balanced against the minimal intrusion upon the States' autonomy, would plainly dictate the constitutionality of Section 310(b). See *South Carolina* v. *Regan*, 465 U.S. at 419 n.18 (Stevens, J., dissenting) ("[T]he federal interest in eliminating a practice which undermines the enforceability of the federal tax system and laws surely is sufficient to outweigh the modest fiscal burdens imposed upon the States by this measure.").

3. *Section 310(b) does not impermissibly "commandeer" state legislative and administrative processes*

The NGA's argument against the validity of Section 310(b) rests not upon *Garcia*, nor upon a *National League of Cities* balancing approach, but rather upon an entirely different and unprecedented theory of the Tenth Amendment. The NGA asserts that Section 310(b) "usurp[s] state political and deliberative processes, requiring the states to pass laws and devote significant administrative resources to implementing the federal plan" favoring registration of municipal bonds (Br. 30). According to the NGA, this "interference" with state government is prohibited by the Tenth Amendment. In making this contention, the NGA does not appear to refer to the *economic* costs incident to a State's passing a law or promulgating a regulation; the Master in any event

found that such economic costs, to the extent they even exist, are not significant. See pages 8-12, *supra*. Rather, the NGA seems to be saying that it is unconstitutional for Congress to pass a law which has the incidental effect of requiring a state governor, or any other state officer, to do *anything* in his or her official capacity.

The NGA's theory, which would impose a limit upon congressional authority far more restrictive than the rule set forth in *National League of Cities*, reflects a complete misunderstanding of this Court's Tenth Amendment jurisprudence. An inevitable consequence of *any* federal regulation of the States' activities is that state governments—through legislative changes, administrative action, or both—must bring their rules into compliance with the applicable federal standard. In *EEOC* v. *Wyoming*, for example, this Court held that the Age Discrimination in Employment Act barred Wyoming from discharging an employee pursuant to a state law that authorized the discharge of an employee who reached the age of 55. The federal law thus required Wyoming to amend both its statute and its administrative standards in order to bring its procedures into compliance with federal requirements. 460 U.S. at 240; see also *id.* at 253-254 n.2 (Burger, C.J., dissenting) (noting that more than half the States had retirement laws that did not comply with the federal statute). *EEOC* v. *Wyoming*, of course, was decided when *National League of Cities* was still the law, and the Court's decision plainly shows that the NGA's theory is untenable.

Indeed, the *National League of Cities* analysis *presupposes* that a State may be required to alter its laws or policies pursuant to a federal standard. The first factor under the *National League of Cities* test, after all, is whether the federal statute regulates the "States as States." A federal law regulates the "States as States," obviously, only if it requires them to alter their conduct in some way, and that alteration will almost invariably entail some change in the relevant state statutes and procedures. This first factor, however, simply triggers the

inquiry under *National League of Cities;* the validity of the federal law depends on the balance of the relevant federal and state interests. The NGA's test, by contrast, would make this initial factor both the beginning and the end of the inquiry. On that approach, any federal statute that regulates the States would be per se unconstitutional.[21]

The NGA's theory, if adopted, would work a revolutionary change in the scope of Congress's regulatory

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[21] The NGA bases its remarkable proposal to expand the Tenth Amendment upon a single decision, *FERC* v. *Mississippi, supra.* But even a cursory examination of the Court's decision in that case makes clear that it will not bear the NGA's tortured reading. The federal statute at issue there required inter alia that state utility commissions consider adopting certain federal standards or cease regulating public utilities. The Court noted that the question posed by that statute was not, as in *National League of Cities,* "the extent to which state sovereignty shields the States from generally applicable federal regulations." The federal statute at issue in *FERC,* rather, "attempt[ed] to use state regulatory machinery to advance federal goals." 456 U.S. at 758-759. The Court ultimately declined to address Congress's power to control the manner in which the States exercised their authority to regulate private parties; instead, the Court upheld the federal statute on the ground that a State was free to cease regulating public utilities if it did not want to consider the federal proposal. See 456 U.S. at 758; see also *id.* at 764 (noting that the issue before the Court concerned the "federal power to compel state regulatory activity"); *id.* at 791 (O'Connor, J., dissenting) (objecting that the federal statute required the "surrender [of] state legislative power" to the federal government). In the instant case, by contrast, the challenged federal statute does not seek to control the manner in which States regulate private parties; the question here, rather, as in *National League of Cities,* is whether the States themselves should be "shield[ed] * * * from generally applicable federal regulations" (*FERC* v. *Mississippi,* 456 U.S. at 758-759). The NGA's argument thus ignores the crucial distinction drawn by the Court in the very decision on which it relies. See also *Bowen* v. *American Hosp. Ass'n,* No. 84-1529 (June 9, 1986) (plurality opinion), slip op. 30 n.29 (quoting *FERC* v. *Mississippi,* 456 U.S. at 783 (O'Connor, J., dissenting)) ("Important principles of federalism are implicated by any 'federal program that compels state agencies * * * to function as bureaucratic puppets of the Federal Government.' ").

power. That theory would require reconsideration of this Court's decisions in *Fry* v. *United States*, 421 U.S. 542 (1975), *EEOC* v. *Wyoming, supra*, and countless other cases. And it would invite the striking down of federal regulatory requirements whose validity was settled long ago. In the tax area alone, for example, state and local governments have long been required to perform a variety of duties that require them to adopt specific statutes and administrative procedures. State and local governments, for example, must withhold federal income taxes from their employees' wages and remit those taxes to the Treasury. See I.R.C. §§ 3402(a) and 3404. They are required to honor IRS levies issued to collect delinquent taxes from their employees' salaries. *Sims* v. *United States*, 359 U.S. 108, 110-113 (1959). They are required to process "withholding exemption certificates," or "W-4 Forms," furnished by their employees (I.R.C. § 3402(f)), and to supply "W-2 Forms" to their workers by January 31 of each year (I.R.C. § 6051(a)). And they are required to file reports with the IRS, and mail corresponding statements to their residents, concerning the payment of state and local income tax refunds (I.R.C. § 6050E). All of these statutes presumably would be unconstitutional under the NGA's theory.[22]

The expansive rule suggested by the NGA is not supported by precedent or policy and should be rejected by this Court. Section 310(b) does not attempt to harness state power to regulate private parties, but rather is simply a "generally applicable federal regulation[]" that regulates the States themselves (*FERC* v. *Mississippi, supra*, 456 U.S. at 759). And because the balance of state and federal interests so clearly favors the federal government, Section 310(b) would not come close to violating

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[22] Many other types of federal statutes have the same effects. For example, federal environmental laws subject state-owned facilities to a variety of federal regulations. See, *e.g.*, 42 U.S.C. 7602(e) (defining "person" under the Clean Air Act to include States and their political subdivisions).

the Tenth Amendment under a *National League of Cities* approach; it is thus valid, *a fortiori*, under *Garcia*.

B. Section 310(b) Does Not Violate The Doctrine Of Intergovernmental Tax Immunity

As we have discussed, Section 310(b) offers a choice to States and localities. They may issue bonds in registered form and retain the benefits of the tax exemption for the interest that they pay. Or they may issue bearer bonds, the interest on which will be taxable. We believe that the statute, by affording this choice to municipal issuers, is *less* burdensome than would be a statute that simply barred them from issuing bearer bonds altogether. Thus, if a statute that effected such a blanket bar would be valid—and we have just demonstrated that it would be—it seems to us that the validity of Section 310(b)(1) follows *a fortiori*.

South Carolina seems to agree that Congress could bar the issuance of all bearer bonds and simply require "registration of state bond issues" (Br. 66-67). Plaintiff nevertheless argues that the lesser step represented by Section 310(b) is unconstitutional, on the theory that the sanction chosen by Congress to encourage registration of state bond issues—loss of tax exemption on the interest if the States do otherwise—is a sanction that Congress has no power to threaten. This argument is based on the notion that, under the doctrine of intergovernmental tax immunity, the tax exemption for municipal bond interest must remain absolute and unconditional.

South Carolina's argument has a highly abstract quality. As we have noted, municipal bond issuers without exception have elected to comply with the incentive that Section 310(b) provides, so that all municipal bonds issued since the statute's effective date have been in registered form (Report 23-24). In practical effect, therefore, Section 310(b) has produced a "bottom line" identical to that which would have been produced by a simple regulatory prohibition of the sort South Carolina concedes to be permissible. Under these circumstances, we

do not believe that it is necessary for the Court even to consider South Carolina's intergovernmental tax immunity argument, an argument that the NGA has in our view wisely abandoned. See NGA Br. 23-25.

If one assumes that resolution of South Carolina's tax-immunity claim is necessary to a decision here, it is essential at the outset to define the true scope of that question. In enacting Section 310(b)(1), Congress did not purport to abolish the federal tax exemption for municipal bond interest. Rather, Congress simply placed a minor and nonburdensome limitation on the exemption's availability. In deciding this case, therefore, there is no need for the Court to decide whether the tax immunity doctrine would prevent Congress from repealing the interest exemption altogether. Rather, as the Special Master observed (Report 143):

> The more narrow issue presented is whether the intergovernmental tax immunity doctrine requires Congress to maintain the exemption for municipal bond interest intact and sacrosanct—regardless of the burden (or lack thereof) imposed upon the States by * * * the threatened loss of that exemption.

South Carolina contends (Br. 27) that the controlling guidepost in resolving that issue is *Pollock* v. *Farmers' Loan & Trust Co.*, 157 U.S. 429 (1895), in which this Court invalidated a statute imposing a federal income tax on municipal bond interest. South Carolina's basic position is that *Pollock*'s holding and rationale prevent Congress from restricting the interest exemption in any manner whatsoever. We agree with Justice Stevens and the Special Master that the rationale on which *Pollock* was based cannot stand today, and that the minor restriction effected by Section 310(b)(1) is valid under the intergovernmental tax immunity doctrine as it has been developed in this Court's modern decisions. See *South Carolina* v. *Regan*, 465 U.S. at 407, 415 (Stevens, J., dissenting) ("[T]he conceptual basis for *Pollock* ha[s] been undermined" by the Court's modern jurisprudence

and "[t]here is simply nothing left of *Pollock* on which South Carolina can base a claim."); Report 141-184.[23]

1. *The rationale enunciated in* Pollock *no longer governs the scope of state immunity from federal taxation*

The Special Master's Report (at 148-181) discusses the evolution of the intergovernmental tax immunity doctrine in great detail. We will attempt to summarize that story —a rather long and complex story—here, paying particular attention to the evolution of the doctrine's *rationale*. As our summary shows, the repudiation of the reasoning enunciated in *Pollock* is absolutely unmistakable from this Court's subsequent decisions.

a. The *Pollock* decision was one of several cases, all decided during the last third of the Nineteenth Century and the early years of the Twentieth, that accorded the doctrine of state immunity from federal taxation an extremely broad scope. This series of decisions began with *Collector* v. *Day*, 78 U.S. (11 Wall.) 113 (1871). The Court there held that it was unconstitutional for Congress "to impose a tax upon the salary of a judicial officer of a State" (78 U.S. at 122). The Court reasoned that a state judicial officer "was a means or instrumentality employed for carrying into effect * * * the legitimate powers of the government"; that "the salary or compensation for the service of [such an] officer was inseparably connected with the office"; and that "if the officer, as such, was exempt, the salary assigned for his support * * * was also, for like reasons, equally exempt" (*id.* at 122-123). A federal tax upon a state officer's salary, the Court surmised, would unconstitutionally threaten the "unimpaired existence" of the States (*id.* at 127).

[23] Because the federal tax laws, from the enactment of the modern income tax in 1913 to the present, have continuously provided an explicit statutory exemption for most municipal bond interest (compare, *e.g.*, Act of Oct. 3, 1913, ch. 16, § II(B), 38 Stat. 168, with I.R.C. §§ 103 and 103A), this Court has not found it necessary to consider whether the holding of *Pollock* remains good law.

In *Pollock*, the Court employed similar reasoning to invalidate a tax imposed "upon the income derived from municipal bonds" (157 U.S. at 583) by the Act of August 27, 1894, ch. 349, § 28, 28 Stat. 553. The Court cited *Collector* v. *Day*, *supra*, for the proposition that "Congress ha[s] no power, even by an act taxing all incomes, to levy a tax upon the salaries of judicial officers of a State" (157 U.S. at 584). The Court held in *Pollock* that there was a similar want of congressional power to levy a nondiscriminatory income tax upon the interest earned by a state's lenders (*id.* at 585-586).

The Court in *Pollock* rejected any distinction between a tax imposed directly upon the property or revenues of a State and a tax upon the income that investors "derive[] from state, county, and municipal securities" (157 U.S. at 585). A tax upon the interest income, the Court reasoned, was in essence " 'a tax on the contract' " between the government and its bondholders (*id.* at 586, quoting *Weston* v. *City Council*, 27 U.S. (2 Pet.) 449, 468 (1829)). " 'The right to tax the contract to any extent,' " the Court continued, " 'must * * * have a sensible influence upon the contract' " and hence must be " 'a burthen on the operations of government' " (*ibid.* (quoting *Weston*, 27 U.S. at 468)). The Court accordingly held that a federal tax on municipal bond interest, because it "would operate on the power to borrow before it is exercised" and have a "sensible influence on the [State's] contract" with its lenders, was in substance "a tax on the power of the States and their instrumentalities to borrow money, and consequently [was] repugnant to the Constitution" (157 U.S. at 586).[24]

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[24] The expansive conception of state tax immunity embraced in *Pollock* and *Collector* v. *Day*, *supra*, survived (albeit only barely) into the 1930s. In *Burnet* v. *Coronado Oil & Gas Co.*, 285 U.S. 393 (1932), the Court invalidated a federal tax on the income derived by a corporate lessee from the production of oil and gas on lands leased from a State. Over strong dissents by Justices Brandeis, Stone, Roberts and Cardozo (285 U.S. at 401-413), the Court reasoned that the lease was "an instrumentality of the State" for the exploitation of lands dedicated to public purposes—in that case,

b. The Court has not had occasion expressly to reconsider its holding in *Pollock*. See note 23, *supra*. As Justice Stevens has pointed out, however, the Court's recent decisions make it unmistakably clear that "*Pollock* [is] no longer good law" (*South Carolina* v. *Regan*, 465 U.S. at 407 (Stevens, J., dissenting)). The Court has not cited the holding of *Pollock* since 1938 and has not relied on *Pollock* for a holding since the passage of the Sixteenth Amendment. See 465 U.S. at 412 n.10 (Stevens, J., dissenting). The Court has explicitly overruled *Collector* v. *Day*, *supra*, the precedent on which *Pollock* chiefly relied. See *Graves* v. *New York ex rel. O'Keefe*, 306 U.S. 466, 486 (1939). And the Court has explicitly overruled one of *Pollock*'s principal progeny. See *Helvering* v. *Mountain Producers Corp.*, 303 U.S. 376, 387 (1938), overruling *Burnet* v. *Coronado Oil & Gas Co.*, 285 U.S. 393 (1932) (discussed in note 24, *supra*).

Of special relevance here, the Court has repeatedly limited *Pollock* in subsequent cases involving federal taxation of municipal bonds. Thus, the Court has held that the testamentary transfer of municipal bonds may be subjected to federal estate tax (*Greiner* v. *Lewellyn*, 258 U.S. 384 (1922)). It has held that the inter vivos transfer of municipal bonds may be subjected to federal gift tax (see *Willcuts* v. *Bunn*, 282 U.S. 216, 230 (1931)). And it has held that capital gains realized on the sale of municipal bonds may be subjected to federal income tax (*Willcuts* v. *Bunn*, 282 U.S. at 227-234). Indeed, the interest paid on several species of municipal bonds—certain industrial development bonds, arbitrage bonds,

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the support of public schools (285 U.S. at 398). "To tax the income of the lessee arising" from the lease, the Court held, "would amount to an imposition upon the lease itself" and hence "would burden [the State] in the performance of [its] governmental function" (285 U.S. at 398, 400-401). Citing *Pollock* and *Collector* v. *Day*, the Court ruled (285 U.S. at 400) that any burden upon " 'the instrumentalities, means and operations whereby the States exert [their] governmental powers' " was forbidden by the Constitution (*ibid.*, quoting *Indian Motocycle Co.* v. *United States*, 283 U.S. 570, 575 (1931)).

and mortgage subsidy bonds—is now and has for many years been subject to federal income tax (see note 11, *supra*), and the constitutionality of these provisions has never been seriously questioned.

Most importantly, the Court has explicitly and repeatedly repudiated the conceptual basis on which *Pollock* rested. The *Pollock* decision, in common with the other decisions spawned by *Collector* v. *Day*, *supra*, advanced two theories, closely related yet logically distinct, to support its holding that taxation of a State's bondholders was tantamount to taxing the State itself. The first may be called the "immunity of the source" doctrine. This doctrine was based on the notion that the income generated by certain kinds of state contracts—such as employment contracts, debt obligations, and leases—was "inseparably connected" with the contract itself (*Collector* v. *Day*, 78 U.S. at 122). Since the ultimate source of the income generated by such contracts—the State's power to employ judges, to borrow money, or profitably to administer its lands—was concededly immune from federal tax, it was said that the income generated must necessarily be immune from tax as well. See *Collector* v. *Day*, 78 U.S. at 122-123, 127; *Pollock*, 157 U.S. at 586; *Burnet* v. *Coronado Oil & Gas Co.*, 285 U.S. at 398, 400-401.

The second theory on which *Pollock* relied has been aptly described as the " 'intergovernmental burden' " doctrine. *South Carolina* v. *Regan*, 465 U.S. at 406 (Stevens, J., dissenting). The rationale of that doctrine was that, "even though a tax is not laid directly upon another government, if it has a 'sensible influence' on the costs incurred by that government, it must fall" (*ibid.* (quoting *Pollock*, 157 U.S. at 585-586)). The Court in the *Pollock* line of cases surmised that a tax on the income derived by an individual from his dealings with the State would cause the latter to experience either increased costs (*e.g.*, higher salaries or interest rates) or decreased revenues (*e.g.*, lower leasehold income). In either event, it was said that the tax would impermissibly

"burden [the State] in the performance of [its] governmental function." *Burnet* v. *Coronado Oil & Gas Co.*, 285 U.S. at 398; see also *Pollock*, 157 U.S. at 586.

Both the "immunity of the source" theory and the "intergovernmental burden" theory have been expressly abandoned by the Court in its modern jurisprudence. The repudiation of those doctrines is perhaps most clearly shown in the Court's decisions allowing the federal government to tax the income of state officers, employees, and contractors. *Metcalf & Eddy* v. *Mitchell*, 269 U.S. 514 (1926); *Helvering* v. *Gerhardt*, 304 U.S. 405 (1938); cf. *James* v. *Dravo Contracting Co.*, 302 U.S. 134 (1937) (allowing state governments to tax the income of federal contractors); *Graves* v. *New York ex rel. O'Keefe*, 306 U.S. 466 (1939) (allowing state governments to tax the income of federal employees). It is to a discussion of that line of cases that we now turn.

c. In *Metcalf & Eddy*, the Court sustained the constitutionality of a federal income tax on the compensation earned by consulting engineers for services rendered under contracts with state and local governments (269 U.S. at 518-519). The Court noted that, under *Pollock* and *Collector* v. *Day*, certain contracts and other "instrumentalities" of a state government were deemed to be "so intimately connected with [its] necessary functions" that the immunity from federal taxation "extend[ed] not only to the instrumentality itself but to income derived from it" (269 U.S. at 522). The Court, however, drew a distinction (*id.* at 524-525) between income taxes on independent contractors and the income taxes involved in those earlier cases:

> [H]ere the tax is imposed on the income of one who is neither an officer nor an employee of government and whose only relation to it is that of contract * * *. The tax is imposed without discrimination upon income whether derived from services rendered to the state or services rendered to private individuals. In such a situation it cannot be said that the tax is imposed upon an agency of government in any technical sense, and the tax itself cannot be deemed

> to be an interference with government, or an impairment of the efficiency of its agencies in any substantial way.

The Court accordingly held (269 U.S. at 526) that "one who is not an officer or employee of a state does not establish exemption from federal income tax merely by showing that his income was received * * * under a contract with the state."

In *Helvering* v. *Gerhardt*, 304 U.S. at 417, 424, the Court confined *Collector* v. *Day* to its facts and sustained the constitutionality of a federal income tax on the salaries of state employees. The Court acknowledged that the tax would "deprive[] the states of the advantage of paying less than the standard rate for the services which they engage" and would "increase somewhat the cost of state governments because * * * the taxation of income tends to raise * * * the price of labor and materials" (304 U.S. at 420-421). The Court noted, however, that various classes of taxpayers—those deriving income from the performance of state contracts, from the lease of state lands, and from the profitable resale of state bonds—had recently "been held subject to federal income tax notwithstanding its possible economic burden on the state" (*id.* at 418-419 n.6), and the Court held that a nondiscriminatory tax laid on the net income of state employees was similarly invulnerable to constitutional challenge (*id.* at 420). "The mere fact that the economic burden of such taxes may be passed on to a state government and thus increase * * * the expense of its operation," the Court wrote, "infringes no constitutional immunity. Such burdens are but the normal incidents of the organization within the same territory of two governments, each possessed of the taxing power" (*id.* at 422).

In *Graves* v. *New York ex rel. O'Keefe*, 306 U.S. at 486, the Court explicitly overruled *Collector* v. *Day* and held that both the federal and the state governments may constitutionally impose nondiscriminatory income taxes upon the salaries of the other's officers. The Court noted that such taxes are "measured by income which becomes

the property of the taxpayer when received as compensation for his services" and that such taxes are "paid from [the employee's] private funds and not from the funds of the government, either directly or indirectly" (306 U.S. at 480). "The theory, which once won a qualified approval, that a tax on income is legally or economically a tax on its source" was, the Court held, "no longer tenable" (*ibid.*). Thus, the Court continued, "the only possible basis for implying a constitutional immunity from [an] income tax [on an officer's] salary [was] that the economic burden of the tax is in some way passed on" to the government providing him with the job (*id.* at 481). The Court, however, explicitly rejected that intergovernmental-burden argument, concluding that "[i]n no case is there basis for the assumption that any such tangible or certain economic burden is imposed on the government concerned as would justify a court's declaring that the taxpayer is clothed with the implied constitutional tax immunity of the government by which he is employed" (*id.* at 486). "In this respect," the Court said, "we perceive no basis for a difference in result whether the taxed income be salary or some other form of compensation" (*ibid.*).

d. As Justice Stevens has correctly observed (*South Carolina* v. *Regan*, 465 U.S. at 408 (Stevens, J., dissenting)), the line of decisions culminating in *Graves* makes "the repudiation of *Pollock* * * * unmistakable." For purposes of analysis under the doctrine of intergovernmental tax immunity, a State's bondholders and other lenders stand in precisely the same position vis-a-vis the State as do its officers, employees and independent contractors. Each has entered into a contract with the State, be it an employment contract or a negotiable bond. Each derives income from his contractual dealings with the State, representing a return either upon his labor or upon his capital. The economic effect of taxing each taxpayer's income is to increase the State's cost, whether its cost of acquiring capital or of acquiring labor, by some indefinite amount. And the result of transferring

such an increased cost to the State is arguably to burden it in the exercise of its sovereign powers, be it the power to borrow money or the power to hire officials to administer its laws.

In the *Gerhardt* line of cases, the Court held that a state officer or employee cannot immunize his salary from a nondiscriminatory federal income tax either on the "immunity of the source" theory, by arguing that his contract with the State is immune from tax, or on the "intergovernmental burden" theory, by arguing that the federal tax would have the effect of increasing his state employer's costs. A state bondholder has no better claim under either theory to any constitutional immunity from tax on his interest income. As Justice Stevens has noted, the costs imposed on the States by compliance with Section 310(b), as well as the costs that would be imposed on the States by elimination of the tax exemption for municipal bond interest, are surely small when "compared to the costs imposed on States and localities because their employees' salaries are federally taxed—a burden that the Federal Government unquestionably has the constitutional power to impose" (*South Carolina* v. *Regan*, 465 U.S. at 415-416 (Stevens, J., dissenting)).[25]

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[25] South Carolina attempts to distinguish the *Gerhardt* line of cases (Br. 53) on the ground that interest paid to a State's bondholders is somehow more "essential" to the maintenance of a state government than salaries paid to its officers and employees. See also Pennsylvania Br. 12. This argument is altogether meritless. The premise of *Collector* v. *Day*, which held that a state judge's salary was immune from federal tax, was that "the establishment of [a] judicial department" and "the appointment of [judges] to administer their laws" were "sovereign and reserved rights" of the States without which "no one of the States under the form of government guaranteed by the Constitution could long preserve its existence" (78 U.S. at 126). The immunity of such salaries from federal taxation was said to be necessitated "by the great law of self-preservation" (*id.* at 127). It can scarcely be contended that the interest a State pays its lenders is more central to preservation of its sovereignty than the salaries it pays to its policemen, firemen, legislators, judges, and governor. Yet *Collector* v. *Day* has nevertheless been overruled.

2. ***Section 310(b) does not violate modern principles of intergovernmental tax immunity***

a. The present contours of the intergovernmental tax immunity doctrine appear perhaps most clearly in this Court's decisions concerning *federal* immunity from *state* taxation. The course of those decisions has closely paralleled the line of decisions concerning state tax immunity discussed above. The Court has held, for example, that the States may constitutionally impose a nondiscriminatory tax on the salaries of federal employees,[26] on the income of federal contractors,[27] and on the profits of federal lessees.[28] The Court's recent decisions make clear that " 'immunity may not be conferred simply because the tax has an effect on the United States, or even because the Federal Government shoulders the entire economic burden of the levy.' " *Washington* v. *United States*, 460 U.S. 536, 540 (1983) (quoting *United States* v. *New Mexico*, 455 U.S. 720, 734 (1982)). To the contrary, "[s]o long as the tax is not directly laid on the Federal Government, it is valid if nondiscriminatory." *United States* v. *County of Fresno*, 429 U.S. 452, 460 (1977).

The Court's recent cases thus teach that the federal government can claim immunity from a state tax in only two circumstances. The first is where "the levy falls on the United States itself, or an agency or instrumentality so closely connected to the Government that the two cannot realistically be viewed as separate entities." *United States* v. *New Mexico*, 455 U.S. at 735. The second is where the state tax, while not falling directly on the United States, falls in discriminatory fashion upon those who deal with the United States, thus transferring to the federal government an economic burden whose asym-

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[26] *Graves* v. *New York ex rel. O'Keefe*, 306 U.S. at 492 (overruling *Dobbins* v. *Commissioners*, 41 U.S. (16 Pet.) 435 (1842)).

[27] *James* v. *Dravo Contracting Co.*, 302 U.S. at 149-157.

[28] *Helvering* v. *Mountain Producers Corp.*, 303 U.S. at 387 (overruling *Gillespie* v. *Oklahoma*, 257 U.S. 501 (1922)).

metricality makes it unfair. "[T]he economic burden * * * of a state tax imposed on those who deal with the Federal Government," in other words, "does not render the tax unconstitutional so long as the tax is imposed on the other similarly situated constituents of the State." *United States* v. *County of Fresno*, 429 U.S. at 462 (footnote omitted).[29]

Since the federal government's immunity from state taxation is based upon the Supremacy Clause (*McCulloch* v. *Maryland*, 17 U.S. (4 Wheat.) 316 (1819)), it is obvious that the States' immunity from federal taxation can have no greater compass.[30] As a result, "an economic burden on traditional state functions without more is not a sufficient basis for sustaining a claim of immunity." *Massachusetts* v. *United States*, 435 U.S. at 461 (plurality opinion). Rather, South Carolina could prevail on its challenge to Section 310(b) under the intergovernmental tax immunity doctrine only by demonstrating *either* that the statute imposes a tax directly upon the States *or* that the statute discriminates against the States. South Carolina has not seriously attempted to prove either of these things, and it is obvious that it cannot do so.[31]

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[29] The Court emphasized in the *Graves* line of cases that the income taxes there upheld applied nondiscriminatorily to income earned by persons in both public and private employment. See *Graves*, 306 U.S. at 484-486; *Gerhardt*, 304 U.S. at 420-421; *Metcalf & Eddy*, 269 U.S. at 524. In the case of such nondiscriminatory taxes, a plurality of this Court has recently explained (*Massachusetts* v. *United States*, 435 U.S. 444, 458-459 (1978) (citations omitted)), the tax "will no more preclude the States from performing traditional functions than it will prevent private entities from performing their missions."

[30] Any other conclusion, of course, would turn the Supremacy Clause upside-down. The Court in *Helvering* v. *Gerhardt*, *supra*, firmly rejected any such notion, pointing out (304 U.S. at 412) that federal immunity from state taxation, if anything, has a greater scope than its state counterpart.

[31] The Special Master suggested that a tax immunity might be available in a third situation—if a State could show that "the

First, Section 310(b)(1) does not impose a "tax" on South Carolina or its agencies. South Carolina may have incurred some minor transaction costs incident to issuing its bonds in registered form, but those compliance costs, contrary to the State's assertion (Br. 60-62), are plainly not a "tax." See Report 185-187. And even if South Carolina had elected to continue issuing its bonds in bearer form, thus forfeiting the tax exemption pursuant to Section 310(b)(1), there would still be no tax on the State or its agencies. Rather, the tax would fall on those with whom the State deals—its bondholders. While the effect of such a tax on the bondholders might be to transfer an economic burden to the State, that fact, as we have just explained, is constitutionally irrelevant. *Massachusetts* v. *United States*, 435 U.S. at 461 (plurality opinion).

Second, Section 310(b), despite South Carolina's assertion to the contrary (Br. 57), does not "discriminate" against the States. Rather, the statute's registration provision applies to *all* issuers of bonds—state and local governments, private corporations, and the United States

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actual impact of [a federal tax] threaten[ed] the continued existence of the States or interfere[d] unduly with their ability to perform essential government functions." Report 181; see also *id.* at 184 n.486. This standard, which does not appear in this Court's decisions construing the tax immunity doctrine, seems to be borrowed from the Commerce Clause context in general, and from the *Garcia* decision in particular. We are not at all sure that this additional test is either a necessary or an appropriate component of a tax immunity doctrine. Other than as the product of a tax imposed directly upon a State—which would be precluded by the existing tax immunity doctrine—it is difficult to imagine how a burden of the sort contemplated by the Master ever could result from a nondiscriminatory tax. And if the onerous federal tax hypothesized by the Master were *not* imposed directly on the State, consideration of any purely economic burden transferred to the State would be foreclosed by *Gerhardt*. In any event, debate about the existence of such a third basis for tax immunity is entirely hypothetical. The Master expressly found that the factual predicate—a burden on the States that threatens their continued existence—is wholly lacking in this case. See Report 181-182.

itself. See Report 137, 181-182. The incentives that Congress has created to induce private and municipal issuers to register their bonds, of course, necessarily vary because of the different tax status of the respective issuers. But the sanctions that attend noncompliance are essentially analogous and are of comparable severity in economic terms.[32] Under these circumstances, it cannot seriously be contended that the registration requirement discriminates as between States and private issuers—unless it discriminates in favor of the States.

The nondiscriminatory nature of the challenged statute is even more clearly shown by the fact that the federal government has imposed upon itself the same registration requirement that it has imposed upon the States. See Pub. L. No. 97-248, § 310(a), 96 Stat. 595-596 (mandating registration of substantially all long-term bonds issued by the United States, its agencies and instrumentalities). Moreover, even if a State were to refuse to comply with the registration requirement, and were thus to incur loss of tax exemption for the interest paid on its bonds, there would still be no discrimination between federal and state obligations. The interest paid on most federal bonds has long been subject to federal income tax. Public Debt Act of 1941, ch. 7, § 4(a),

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[32] In the case of private corporations, Congress provided that noncompliance would entail loss of ability to deduct the interest against corporate gross income, loss of ability to offset the interest against corporate earnings-and-profits accounts, and a heavy excise tax upon issuance of the bonds. Pub. L. No. 97-248, § 310(b)(2), (3) and (4), 96 Stat. 596-598. Since States do not pay income tax and do not have earnings-and-profits accounts, the first two of those incentives obviously could have no possible application to the States. The incentive that Congress instead chose to encourage compliance by the States (inclusion of the interest in the bondholder's income) is essentially reciprocal to one of the corporate sanctions (denial of a deduction against the issuer's income) and is of comparable severity in economic terms. In fact, the *aggregate* sanctions for noncompliance are greater in the case of private corporations, for they risk a substantial excise tax that noncompliant municipal issuers are spared. See I.R.C. § 4701(a) and (b)(1).

55 Stat. 9. See Tax Reform Act of 1976, Pub. L. No. 94-455, § 1901(a)(17), 90 Stat. 1765-1766 (repealing 26 U.S.C. (1970 ed.) 103(a)(2) and (3)).[33]

In *Massachusetts* v. *United States*, the Court held that a federal aviation tax was nondiscriminatory and hence not violative of state tax immunity, noting that the tax applied not only to aircraft owned by States and private users "but also to civil aircraft operated by the United States" (435 U.S. at 467). These facts, the Court held, "minimize, if not eliminate entirely, the basis for a conclusion that [the levy] might be an abusive exercise of the taxing power" (*ibid.*). Justice Stevens correctly reached the same conclusion, for similar reasons, in the instant case. "Even in the heydey of *Pollock*," he noted, "the Court never held that the Federal Government impermissibly infringed state sovereignty by imposing a burden on States that it also imposed on itself. If Congress has destroyed some protected concept of state sovereignty through [I.R.C.] § 103(j)(1), then it has destroyed the sovereignty of the United States as well." *South Carolina* v. *Regan*, 465 U.S. at 417 (Stevens, J., dissenting).[34]

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[33] The interest paid on federal obligations is exempt from *state* income tax by statute. See 31 U.S.C. 3124(a). Under the Supremacy Clause, Congress has the power to create tax immunities for the federal government and for its agencies and instrumentalities. See, *e.g.*, *Carson* v. *Roane-Anderson Co.*, 342 U.S. 232, 234 (1952).

[34] In contending that a federal income tax on municipal bond interest would be unconstitutional, South Carolina (Br. 42-45) and amicus GFOA (Br. 7-23) rely on the legislative history of the Sixteenth Amendment. That legislative history shows that Congress in 1913, as was natural in view of *Pollock*, entertained doubts about its power to tax municipal bond interest; the Amendment's sponsors, furthermore, assured Congress that the Amendment's passage would not, in and of itself, authorize taxation of such interest. See Report 163 n.463; GFOA Br. 10. Amicus argues, in essence, that the view of the tax immunity doctrine current in 1913 was somehow "frozen" into the text of the Sixteenth Amendment, assertedly making this Court's more recent decisions—which have

undermined *Pollock* and rewritten the tax immunity doctrine—irrelevant in determining whether a federal tax on municipal bond interest would be valid.

The Special Master correctly rejected this argument (Report 162-163 & n.463). The Sixteenth Amendment had no effect, one way or the other, on the scope of the federal taxing power; the Amendment was designed merely to abolish the apportionment requirement for so-called "direct taxes." See *Brushaber* v. *Union Pac. R.R.*, 240 U.S. 1, 12-19 (1916). Thus, as the Special Master explained (Report 163 n.463):

> [T]he Sixteenth Amendment did not purport to address the scope of the federal taxing power as applied to activities of the States. That the sponsors of this constitutional amendment shared the then prevailing view of the scope of intergovernmental tax immunity is not surprising; however, their endorsement of that interpretation can neither transform the Sixteenth Amendment into an adoption of that interpretation, given the wholly unrelated purpose of the Amendment, nor detract from [this Court's more recent] cases limiting the scope of intergovernmental tax immunity.

The correctness of the Master's conclusion is shown by this Court's decisions permitting federal taxation of state employees' salaries. Congress at the time of the Sixteenth Amendment entertained grave doubts about its power to tax such salaries, as was again natural in view of this Court's decision in *Collector* v. *Day*. See, *e.g.*, 50 Cong. Rec. 508 (1913) (Rep. Hull); 56 Cong. Rec. 10628 (1918) (Sen. Thomas). It was in part because of those misgivings that Congress included in the first modern income tax law an explicit exemption for such salaries. Act of Oct. 3, 1913, ch. 16, § II(B), 38 Stat. 168. After Congress repealed the exemption for state employees' salaries (compare, *e.g.*, Revenue Act of 1928, ch. 852, § 22, 45 Stat. 797-798, with War Revenue Act of 1917, ch. 63, § 201(a), 40 Stat. 303), this Court sustained the constitutionality of the tax as thus applied, and did so without even mentioning the legislative history of the Sixteenth Amendment. See *Graves* v. *New York ex rel. O'Keefe*, 306 U.S. at 475-487; *Helvering* v. *Gerhardt*, 304 U.S. at 410-424. Obviously, if the view of the tax immunity doctrine current in 1913 had been "frozen" into the text of the Sixteenth Amendment, federal taxation of state employees' salaries would be unconstitutional. This Court's decisions permitting such taxation, as well as the Court's oft-repeated admonition that "[e]xemptions from taxation do not rest upon implication" (*United States Trust Co.* v. *Helvering*, 307 U.S. 57,

CONCLUSION

The exceptions to the Special Master's Report should be overruled, the recommendations of the Special Master approved, and judgment entered for defendant.

Respectfully submitted.

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60 (1939) (citing cases)), thus show that amicus's theory is insupportable.

Finally, we view with great skepticism that principle underlying amicus's argument—that this Court's authority to reconsider constitutional doctrine has in essence been "repealed by implication" even though there is nothing in the text of the Sixteenth Amendment to support that result. Considerably more than a few ambiguous comments in legislative history should be required before this Court is divested of its discretion to perform its " 'gravest and most delicate duty' " (*Rostker* v. *Goldberg*, 453 U.S. 57, 64 (1981) (citation omitted))—assessing the constitutional limits upon the authority of Congress.

APPENDIX

Section 310 of the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 595-600 (originally codified at 31 U.S.C. 3121(g) and 26 U.S.C. 103(j), 163(f), 165(j), 312(m), 1232(c) and 4701) provides:

SEC. 310. OBLIGATIONS REQUIRED TO BE REGISTERED.

(a) UNITED STATES OBLIGATIONS.—The Second Liberty Bond Act is amended by adding at the end thereof the following new section:

"SEC. 28. (a) Every registration-required obligation of the United States (or of any agency or instrumentality thereof) shall be in registered form.

"(b) For purposes of this section—

"(1) Except as provided in paragraph (2), the term 'registration-required obligation' means any obligation other than an obligation which—

"(A) is not a type offered to the public, or

"(B) has a maturity (at issue) of not more than 1 year.

"(2) The term 'registration-required obligation' shall not include any obligation if—

"(A) there are arrangements reasonably designed to ensure that such obligation will be sold (or resold in connection with the original issue) only to a person who is not a United States person, and

"(B) in the case of an obligation not in registered form—

"(i) interest on such obligation is payable only outside the United States and its possessions, and

"(ii) on the face of such obligation there is a statement that any United

States person who holds such obligation will be subject to limitations under the United States income tax laws.

"(c) (1) For purposes of subsection (a), a book entry obligation shall be treated as in registered form if the right to principal of, and stated interest on, such obligation may be transferred only through a book entry consistent with regulations prescribed by the Secretary of the Treasury.

"(2) The Secretary of the Treasury shall prescribe such regulations as may be necessary to carry out the purpose of subsection (a) where there is a nominee or chain of nominees.".

(b) OTHER OBLIGATIONS.—

(1) OBLIGATIONS MUST BE IN REGISTERED FORM TO BE TAX-EXEMPT.—Section 103 (relating to interest on certain governmental obligations) is amended by redesignating subsection (j) as subsection (k) and by inserting after subsection (i) the following new subsection:

"(j) OBLIGATIONS MUST BE IN REGISTERED FORM TO BE TAX-EXEMPT.—

"(1) IN GENERAL.—Nothing in subsection (a) or in any other provision of law shall be construed to provide an exemption from Federal income tax for interest on any registration-required obligation unless the obligation is in registered form.

"(2) REGISTRATION-REQUIRED OBLIGATION.— The term 'registration-required obligation' means any obligation other than an obligation which—

"(A) is not a type offered to the public,

"(B) has a maturity (at issue) of not more than 1 year, or

"(C) is described in section 163(f)(2)(B).

"(3) SPECIAL RULES.—

"(A) BOOK ENTRIES PERMITTED.—For purposes of paragraph (1), a book entry obligation shall be treated as in registered form if the right to the principal of, and stated interest on, such obligation may be transferred only through a book entry consistent with regulations prescribed by the Secretary.

"(B) NOMINEES.—The Secretary shall prescribe such regulations as may be necessary to carry out the purpose of paragraph (1) where there is a nominee or chain of nominees."

(2) DENIAL OF DEDUCTION FOR INTEREST IF OBLIGATION NOT IN REGISTERED FORM.—Section 163 (relating to deduction for interest) is amended by redesignating subsection (f) as subsection (g) and by inserting after subsection (e) the following new subsection:

"(f) DENIAL OF DEDUCTION FOR INTEREST ON CERTAIN OBLIGATIONS NOT IN REGISTERED FORM.—

"(1) IN GENERAL.—Nothing in subsection (a) or in any other provision of law shall be construed to provide a deduction for interest on any registration-required obligation unless such obligation is in registered form.

"(2) REGISTRATION-REQUIRED OBLIGATION.—For purposes of this section—

"(A) IN GENERAL.—The term 'registration-required obligation' means any obligation (including any obligation issued by a governmental entity) other than an obligation which—

"(i) is issued by a natural person,

"(ii) is not of a type offered to the public,

"(iii) has a maturity (at issue) of not more than 1 year, or

"(iv) is described in subparagraph (B).

"(B) CERTAIN OBLIGATIONS NOT INCLUDED.—An obligation is described in this subparagraph if—

"(i) there are arrangements reasonably designed to ensure that such obligation will be sold (or resold in connection with the original issue) only to a person who is not a United States person, and

"(ii) in the case of an obligation not in registered form—

"(I) interest on such obligation is payable only outside the United States and its possessions, and

"(II) on the face of such obligation there is a statement that any United States person who holds such obligation will be subject to limitations under the United States income tax laws.

"(C) AUTHORITY TO INCLUDE OTHER OBLIGATIONS.—Clauses (ii) and (iii) of subparagraph (A), and subparagraph (B), shall not apply to any obligation if—

"(i) such obligation is of a type which the Secretary has determined by regulations to be used frequently in avoiding Federal taxes, and

"(ii) such obligation is issued after the date on which the regulations referred to in clause (i) take effect.

"(3) BOOK ENTRIES PERMITTED, ETC.—For purposes of this subsection, rules similar to the rules of section 103(j)(3) shall apply."

(3) DENIAL OF EARNINGS AND PROFIT ADJUSTMENT FOR INTEREST ON REGISTRATION-REQUIRED OBLIGATIONS NOT IN REGISTERED FORM.—Section 312 (relating to earnings and profits) is amended by adding at the end thereof the following new subsection:

"(m) NO ADJUSTMENT FOR INTEREST PAID ON CERTAIN REGISTRATION-REQUIRED OBLIGATIONS NOT IN REGISTERED FORM.—The earnings and profits of any corporation shall not be decreased by any interest with respect to which a deduction is not or would not be allowable by reason of section 163(f), unless at the time of issuance the issuer is a foreign corporation that is not a controlled foreign corporation (within the meaning of section 957), a foreign investment company (within the meaning of section 1246(b)), or a foreign personal holding company (within the meaning of section 552) and the issuance did not have as a purpose the avoidance of section 163(f) of this subsection".

(4) EXCISE TAX ON ISSUERS OF REGISTRATION-REQUIRED OBLIGATIONS WHICH ARE NOT IN REGISTERED FORM.—

(A) IN GENERAL.—Subtitle D (relating to miscellaneous excise taxes) is amended by adding after chapter 38 the following new chapter:

"CHAPTER 39—REGISTRATION-REQUIRED OBLIGATIONS

Sec. 4701. Tax on issuer of registration-required obligation not in registered form.

"SEC. 4701. TAX ON ISSUER OF REGISTRATION-REQUIRED OBLIGATION NOT IN REGISTERED FORM.

"(a) IMPOSITION OF TAX.—In the case of any person who issues a registration-required obligation which is not in registered form, there is hereby imposed on such person on the issuance of such obligation a tax in an amount equal to the product of—

"(1) 1 percent of the principal amount of such obligation, multiplied by

"(2) the number of calendar years (or portions thereof) during the period beginning on the date of issuance of such obligation and ending on the date of maturity.

"(b) DEFINITIONS.—For purposes of this section—

"(1) REGISTRATION-REQUIRED OBLIGATION.—The term 'registration-required obligation' has the same meaning as when used in section 163(f), except that such term shall not include any obligation required to be registered under section 103(j).

"(2) REGISTERED FORM.—The term 'registered form' has the same meaning as when used in section 163(f)."

(B) CONFORMING AMENDMENT.—The table of chapters for subtitle D is amended by inserting after chapter 38 the following:

"CHAPTER 39. Registration-required obligations."

(5) DENIAL OF DEDUCTION FOR LOSSES ON CERTAIN OBLIGATIONS NOT IN REGISTERED FORM.—Section 165 (as amended by this Act) is amended by redesignating subsection (j) as subsection (k) and by inserting after subsection (i) the following new subsection:

"(j) DENIAL OF DEDUCTION FOR LOSSES ON CERTAIN OBLIGATIONS NOT IN REGISTERED FORM.—

"(1) IN GENERAL.—Nothing in subsection (a) or in any other provision of law shall be construed to provide a deduction for any loss sustained on any registration-required obligation unless such obligation is in registered form (or the issuance of such obligation was subject to tax under section 4701).

"(2) DEFINITIONS.—For purposes of this subsection—

"(A) REGISTRATION-REQUIRED OBLIGATION.—The term 'registration-required obligation' has the meaning given to such term by section 163(f)(2) except that clause (iv) of subparagraph (A), and subparagraph (B), of such section shall not apply.

"(B) REGISTERED FORM.—The term 'registered form' has the same meaning as when used in section 163(f).

"(3) EXCEPTIONS.—The Secretary may, by regulations, provide that this subsection and subsection (d) of section 1232 shall not apply with respect to obligations held by any person if—

"(A) such person holds such obligations in connection with a trade or business outside the United States,

"(B) such person holds such obligations as a broker dealer (registered under Federal or State law) for sale to customers in the ordinary course of his trade or business,

"(C) such person complies with reporting requirements with respect to ownership, transfers, and payments as the Secretary may require, or

"(D) such person promptly surrenders the obligation to the issuer for the issuance of a new obligation in registered form, but only if

such obligations are held under arrangements provided in regulations or otherwise which are designed to assure that such obligations are not delivered to any United States person other than a person described in subparagraph (A), (B), or (C)."

(6) DENIAL OF CAPITAL GAIN TREATMENT FOR GAINS ON CERTAIN OBLIGATIONS NOT IN REGISTERED FORM.—Section 1232 (relating to bonds and other evidences of indebtedness) is amended by redesignating subsection (d) as subsection (e) and by inserting after subsection (c) the following new subsection:

"(d) DENIAL OF CAPITAL GAIN TREATMENT FOR GAINS ON CERTAIN OBLIGATIONS NOT IN REGISTERED FORM.—

"(1) IN GENERAL.—If any registration-required obligation is not in registered form, any gain on the sale or other disposition of such obligation shall be treated as ordinary income (unless the issuance of such obligation was subject to tax under section 4701).

"(2) DEFINITIONS.—For purposes of this subsection—

"(A) REGISTRATION-REQUIRED OBLIGATION.—The term 'registration-required obligation' has the meaning given to such term by section 163(f)(2) except that clause (iv) of subparagraph (A), and subparagraph (B), of such section shall not apply.

"(B) REGISTERED FORM.—The term 'registered form' has the same meaning as when used in section 163(f)."

(c) TECHNICAL AMENDMENTS.—

(1) Subparagraph (A) of section 103(b)(4) (relating to certain exempt activities) is

amended by striking out "if each obligation issued pursuant to the issue is in registered form and".

(2)(A) Paragraph (1) of section 103(h) (relating to certain obligations must be in registered form and not guaranteed or subsidized under an energy program) is amended by striking out subparagraph (A) and by redesignating subparagraphs (B) and (C) as subparagraphs (A) and (B), respectively.

(B) The subsection heading for subsection (h) of section 103 is amended by striking out "MUST BE IN REGISTERED FORM AND NOT" and inserting in lieu thereof "MUST NOT BE".

(3)(A) Subsection (j) of section 103A (relating to other requirements) is amended by striking out paragraph (1) and by redesignating paragraphs (2) and (3) as paragraphs (1) and (2), respectively.

(B) Subparagraph (B) of section 103A(c)(2) (defining qualified mortgage issue) is amended by striking out "and (f) and paragraphs (2) and (3) of subsection (j)" and inserting in lieu thereof "(f), and (j)".

(C) Subparagraph (C) of section 103A(c)(2) is amended by striking out ", and paragraph (1) of subsection (j)".

(D) Subparagraph (C) of section 103A(c)(3) (defining qualified veterans' mortgage bond) is amended by striking out "subsection (j)(2)" and inserting in lieu thereof "subsection (j)(1)".

(4) Subparagraph (A) of section 103A(c)(3) (defining qualified veterans' mortgage bond) is amended by striking out "in registered form".

(d) EFFECTIVE DATES.—

(1) IN GENERAL.—Except as otherwise provided in this subsection, the amendments made by this section shall apply to obligations issued after December 31, 1982.

(2) LONG-TERM U.S. OBLIGATIONS. — The amendment made by subsection (a) shall apply to obligations issued after the date of the enactment of this Act under the first section of the Second Liberty Bond Act.

(3) EXCEPTION FOR CERTAIN WARRANTS, ETC.—The amendments made by subsection (b) shall not apply to any obligations issued after December 31, 1982, on the exercise of a warrant or the conversion of a convertible obligation if such warrant or obligation was offered or sold outside the United States without registration under the Securities Act of 1933 and was issued before August 10, 1982. A rule similar to the rule of the preceding sentence shall also apply in the case of any regulations issued under section 163(f)(2)(C) of the Internal Revenue Code of 1954 (as added by this section) except that the date on which such regulations take effect shall be substituted for "August 10, 1982".

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No. 94, Original

IN THE

Supreme Court of the United States

October Term, 1987

STATE OF SOUTH CAROLINA,
Plaintiff,

NATIONAL GOVERNORS' ASSOCIATION,
Plaintiff-in-Intervention,

v.

JAMES A. BAKER, III, SECRETARY OF THE TREASURY OF THE UNITED STATES OF AMERICA,
Defendant.

MOTION OF THE NATIONAL GOVERNORS' ASSOCIATION FOR LEAVE TO FILE REPLY BRIEF AND REPLY BRIEF

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August 21, 1987

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JAMES A. BAKER, III, SECRETARY OF THE TREASURY OF THE UNITED STATES OF AMERICA,

Defendant.

MOTION OF THE NATIONAL GOVERNORS' ASSOCIATION FOR LEAVE TO FILE REPLY BRIEF

The National Governors' Association ("NGA"), plaintiff-in-intervention, respectfully requests that this Court grant it leave to file a Brief in Reply to the Defendant's Brief in Support of the Report of the Special Master. Because the defendant Secretary of the Treasury declined to file exceptions to the Report of the Special Master, a reply brief will afford the NGA its only opportunity to respond to the Secretary's arguments before this Court.

On February 23, 1987, the Court instructed each of the parties to file any exceptions to the Special Master's Report, with supporting briefs, within 45 days. The parties then were permitted to file reply briefs 30 days later. On May 9, 1987, pursuant to an

extension granted by this Court, the NGA duly filed its exceptions to the Report of the Special Master. The Solicitor General, however, notified this Court that no exceptions would be filed on behalf of the Secretary of the Treasury.

On July 10, 1987, pursuant to a second extension of time granted by the Court, the Solicitor General, on behalf of the Secretary of the Treasury, filed a brief in response to the NGA's exceptions. Because the Secretary had not filed exceptions with a supporting brief, the NGA could not reply at that time. Accordingly, the NGA respectfully requests this Court now grant it the opportunity to file a brief in reply to the Secretary.

For the foregoing reason, the NGA respectfully requests this Court grant it leave to file its Reply Brief.

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No. 94, Original

IN THE

Supreme Court of the United States

October Term, 1987

STATE OF SOUTH CAROLINA,

Plaintiff,

NATIONAL GOVERNORS' ASSOCIATION,

Plaintiff-in-Intervention,

v.

JAMES A. BAKER, III, SECRETARY OF THE TREASURY OF THE UNITED STATES OF AMERICA,

Defendant.

REPLY BRIEF OF THE NATIONAL GOVERNORS' ASSOCIATION

Plaintiff-in-intervention National Governors' Association (the "NGA") and defendant Secretary of the Treasury (the "Secretary") apparently agree on the proper standards that should guide resolution by the Court of this dispute. In fact, the Secretary's brief in support of the Report of the Special Master makes clear that the only area of substantial disagreement between the Secretary and the NGA concerns application of the appropriate standards to the facts of this case. Before addressing that disagreement, it is useful to summarize the common ground between us.

1. The NGA and the Secretary agree that Section 310(b)(1) of the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. 97-248, 96 Stat. 324, 595, 26 U.S.C. § 103(j) (1982) ("TEFRA") properly is evaluated under Tenth Amendment principles as a direct regulation of the States, and that this Court need not address the intergovernmental tax immunity issue also presented in the original complaint. (Sec'y Br. 38-39; NGA Br. 24.) Section 310(b)(1) on its face does not command compliance, but instead appears to offer a choice, conditioning the federal tax exemption on state and local debt upon registration of that debt.* The Special Master found as a fact, however, that conditional loss of the tax exemption would have consequences so harsh that the clear intent of Congress and the effect of the statute was not to present a choice, but to mandate registration of municipal debt. (Report at 2.) Thus, the Secretary and the NGA believe that Section 310(b)(1) properly is viewed as a direct regulation of the States, and that this Court need only, and should only, address the Tenth Amendment issue. (Sec'y Br. 24; NGA Br. 24.)

2. Next, the NGA and the Secretary are in agreement that although this Court's decision in *Garcia v. San Antonio Metro. Transit Auth.*, 469 U.S. 528 (1985), "altered the landscape of federalism jurisprudence," (Report at 117), that decision did not hold that in the future this Court would

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* Because on its face Section 310(b)(1) does not mandate compliance but seeks to obtain compliance by using loss of the tax exemption as a sanction, plaintiff State of South Carolina challenges Section 310(b)(1) under the intergovernmental tax immunity doctrine. Although the NGA (as does the Secretary) believes that issue is not raised under the facts of this case, if the Court should choose to address the intergovernmental tax immunity issue, the NGA fully supports the merits position of the State of South Carolina that the tax exemption is constitutionally compelled.

refuse altogether to review state challenges to federal enactments. (Sec'y Br. 27; NGA Br. 28.) At earlier stages in this litigation the Secretary seemed to suggest that *Garcia* signalled a complete abdication by this Court of its responsibility to referee disputes between the federal and state governments. (Sec'y Pretrial Mem. 3.) That interpretation of *Garcia* would be inconsistent, however, with the grant of original jurisdiction to this Court,* with this Court's historic role in the constitutional system, *Marbury v. Madison*, 5 U.S. (1 Cranch) 137 (1803), and with the Court's most recent precedent, *South Dakota v. Dole*, No. 86-260 (June 23, 1987) (resolving on merits state challenge to federal enactment).

The NGA and the Secretary both recognize, however, that although this Court has the authority and responsibility to review state challenges to federal enactments, the Court should not lightly or frequently strike such enactments. Rather, the NGA and the Secretary agree that this Court should overturn a federal law regulating the States only in the "extraordinary" or rare case. (Sec'y Br. 27; NGA Br. 29.) This requires defining the circumstances that are so extraordinary as to require judicial intervention to invalidate a federal regulation.

3. The NGA and the Secretary apparently also are in agreement as to the standards that distinguish the extraordinary case where Congress has surpassed constitutional bounds from the case where it has not. The relevant inquiry is whether the challenged federal law amounts to an invalid co-option by the federal Congress of state and local regulatory machinery to further federal ends. (Sec'y Br. 21; NGA

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* *See South Carolina v. Regan*, 465 U.S. 367, 397 (1984) (O'Connor, J., concurring) ("[T]he Framers . . . thought that the original jurisdiction was a necessary substitute for the powers of war and diplomacy that these sovereigns previously had relied upon").

Br. 30, 35.) The test is taken directly from this Court's decision in *FERC v. Mississippi*, 456 U.S. 742 (1982), where the Court distinguished a generally-applicable federal regulation from the special problem raised in *FERC*:

> *National League of Cities*, like *Fry v. United States*, 421 U.S. 542 (1975), presented a problem the Court often confronts: the extent to which state sovereignty shields the States from generally applicable federal regulations. In PURPA, *in contrast, the Federal Government attempts to use state regulatory machinery to advance federal goals.*

FERC v. Mississippi, 456 U.S. at 758-59 (emphasis added). *See also Bowen v. American Hosp. Ass'n*, No. 84-1529 (June 9, 1986) (plurality opinion), slip op. at 30 n.29 (quoting *FERC v. Mississippi*, 456 U.S. at 783 (O'Connor, J.) (dissenting in part, concurring in part) ("Important principles of federalism are implicated by any 'federal program that compels state agencies . . . to function as bureaucratic puppets of the Federal Government'").

The Secretary's brief suggests that the NGA is asking this Court to apply different standards than those suggested by *FERC*, encompassing not just the co-option of state regulatory machinery but any federal regulation that has the "incidental"* effect of requiring state governmental

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* When the Secretary refers to "incidental" effects of federal regulation, he apparently is referring not to some quantitative measure of how burdensome compliance with a federal regulation may be to state government, but simply is using "incidental" as shorthand to refer to a requirement imposed by a generally-applicable regulation. Any quantitative burden test would engage the Court in drawing lines at least as difficult as those required under the abandoned *National League of Cities* test. *See National League of Cities* v. *Usery*, 426 U.S. 833 (1976).

processes to bring state government into compliance. (Sec'y Br. 34-38.) This description of the NGA's test is overbroad, missing the crucial distinction between the state as regulated entity, and the state as regulator.* When Congress pursues its own regulatory ends, it may require compliance by state and local governments as well as by private entities. Compliance by state and local governments with "generally-applicable" regulations of the sort distinguished in *FERC* simply is the cost to the state government of doing business in the federal system. Invalidating all federal enactments that required any state action not only would call into question sound precedent

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* A simple example will suffice to make clear the relevant distinction. Suppose Congress wanted to ensure that all automobiles maintained a certain fuel efficiency. Pursuant to its commerce power, Congress could obtain this regulatory end directly in any number of ways, including regulation of automobile owners that might include periodic inspection. If Congress enacted this legislation, a state government that owned automobiles legitimately would be subject to the law on the same terms as a private entity that owned an automobile. But Congress could not pass a law requiring state governments to establish their own state regulatory programs to achieve the federal goal. That would denigrate the notion of separate and independent state governments, make the State a mere administrative tool of the federal government, and impermissibly divert the State from its own pressing agenda. *Cf. Bowen v. American Hosp. Ass'n*, No. 84-1529 (June 9, 1986) (plurality opinion), slip op. at 28 (regulations promulgated by the Secretary of Health and Human Services invalid, in part because they attempted to set investigative and enforcement priorities for state governments, diverting resources from other pressing programs).

Congress could, of course, provide federal funds to the States, and ask the States, in an exercise of cooperative federalism, to administer the program. That would be a valid approach under Congress' spending power. The critical difference is that the States would have a meaningful choice of whether to participate or not, *see South Dakota v. Dole*, No. 86-260 (June 23, 1987), and would receive federal monies to fund the project.

of this Court, but would unduly hamstring valid regulatory efforts of the national government.

Contrary to the Secretary's assertion, then, the NGA does not take the broad position that *any* enactment requiring some state response is invalid, but relies upon precisely the distinction offered in *FERC*, and adopted by the Secretary in his brief. A federal enactment is invalid if it co-opts state regulatory power to achieve a federal end.* Thus, as with much else, the NGA and the Secretary are in agreement as to the relevant standards that apply in this case.**

* The NGA's main brief set out at length the theoretical and practical importance of proscribing the Congress from commandeering state and local government regulatory machinery to federal ends, as well as the importance of the rule in constitutional jurisprudence. The citizens who ratified the Constitution clearly anticipated that they were establishing two separate governments, a national government of limited powers against a backdrop of separate state governments with independent regulatory authority. (NGA Br. 31.) The national government was free to pursue its own regulatory agenda, and even could preempt state activity in federal areas. (NGA Br. 31.) No matter how broad federal regulatory authority has become, however, it remains interstitial by nature. (NGA Br. 32.) State governments must be left free to pursue their own critical agendas. (NGA Br. 33.) When federal laws usurp state regulatory authority to federal ends, state citizens are deprived of the focus of two separate and independent sovereigns that is "the special mark of American federalism." (NGA Br. 32.)

** The NGA and the Secretary are, with one important exception, also in agreement that the findings of the Special Master should be adopted by this Court. The exception is the Master's finding that no interest rate differential exists between bearer and registered bonds. The error in the Master's finding is failing to take account of the Secretary's own comprehensive and expansive economic study, which showed a differential of roughly 8 basis points. After his study was corrected and the result favored the NGA, the Secretary tried to disavow the study. The NGA believes, however, that the record amply supports the fact that a differential does exist. (NGA Br. 13-15.)

4. Apparently the only area of substantial disagreement between the Secretary and the NGA involves application of the *FERC* distinction to the facts of this case. The NGA maintains that Section 310(b)(1) impermissibly makes use of state and local regulatory machinery to accomplish the federal end. The Secretary disagrees, asserting that Section 310(b)(1) is a valid generally-applicable regulation.

The basis for the Secretary's position apparently is that because Congress required the federal government and private businesses to register their debt simultaneously with its imposition of the registration requirement upon the States, Section 310(b)(1) is, by its terms, "generally-applicable."* Even if this were correct as a factual matter,** however,

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* The Secretary also argues that because Section 310(b)(1) would be valid under *National League of Cities* it is *a fortiorari* valid after *Garcia*. It is difficult to see the relevance of this argument. The NGA's Tenth Amendment theory is derived from *FERC*, not from the *National League of Cities/Garcia* line of cases. The Secretary himself has acknowledged that the principles underlying those cases are very different. Moreover, the difference is one of nature, not of degree. Although a generally-applicable regulation might have survived scrutiny under *National League of Cities* and thus inevitably would be valid after *Garcia*, that offers no insight into the validity or invalidity of a federal enactment such as Section 310(b)(1) that commandeers state regulatory authority to further a federal end and thus raises questions under the different principles at issue in *FERC*.

** Plaintiffs maintain it is not. "Most corporate and Treasury securities had been shifted to registered form well before TEFRA was enacted, and *municipal bonds were thus the only category of bonds* that were still issued largely in bearer form at that time." (Secr'y Br. 20 n.15 (citing Tr. 1211-12, 1216, 1223-26, 1245-50, 1255-57) (emphasis added).) Corporate issuers and the United States shifted to registration because of market efficiencies (Secr'y Br. 5) that state and local issuers did not believe would accrue to them in the very different municipal market. Thus, as a practical matter, state and local issuers were the only ones forced to respond to a federal mandate to issue their bonds in registered form.

Congress nonetheless co-opted the regulatory machinery of the States to accomplish a federal end.

Congress, in enacting Section 310(b)(1), did not have some intrinsic interest in seeing to it that bonds were registered. Rather, Congress apparently hoped to stem a perceived use of bearer bonds to evade federal taxes. (Report at 83-84.) The end Congress had in mind, therefore, was the federal goal of reducing federal tax evasion.*

Congress had ample federal regulatory power available to attack the perceived tax compliance problem without demanding that the States use their regulatory authority to solve the problem. As a regulation in aid of its taxing power, *see M'Culloch v. Maryland*, 17 U.S. (4 Wheat) 316 (1819), Congress could have required all bond transfers to go through brokers in order for the bonds to retain negotiability, or Congress could have required that all bonds be deposited in a central bond depository such as The Depository Trust Company. Either of these would have been more effective tax compliance measures than was registration.**

* Even after the extensive proceedings in this case the record is devoid of any evidence concerning either the extent to which bearer municipal bonds created a tax compliance problem or the extent to which registration addresses that compliance problem. (Report at 84.) Congress' own revenue figures fail to indicate any increased revenue from registration (*id.*), and the Secretary offered no evidence at trial as to the extent of the compliance problem or the revenue benefit of registration. (*Id.*) In sharp contrast, the NGA made a strong case that whatever the extent of the bearer compliance problem, registration does little to address it. The Master conceded the NGA's argument and proof had "some force," (Report at 85), and that "there are limitations to the utility of the registration requirement as an aid to tax enforcement" (Report at 88), but nonetheless deferred to Congress' judgment that there was a compliance problem and registration would address it.

** A broker transfer requirement would have been more effective because brokers currently have the obligation to file information reports with the Internal Revenue Service concerning all bond transactions.

Instead of pursuing these alternatives, both of which were well within federal regulatory grasp, the federal government mandated that the States establish an ongoing regulatory scheme to address the federal problem. State and local bond issuers would be required to monitor bond ownership in case federal agents decided at some point in time to make use of the information. In effect, the States were required to administer a program that keeps records of bond transfers on a daily basis.

Compliance was no simple matter for state government. The States were required to change numerous state laws to permit registration. (Report at 36-38; NGA Br. 9-11.) Significant state administrative resources were redirected merely to establish the regulatory program. (Report at 39-44; NGA Br. 11-12.) Moreover, for the life of each bond issue, state and local issuers must maintain a means of recording bond transfers and responding to Internal Revenue Service inquiries upon request. (Report at 81; NGA Br. 18-19.) In short, state regulatory machinery was co-opted for a purely federal end — monitoring of bond ownership to assist federal tax collection efforts — although the federal government easily could have achieved federal tax compliance goals more effectively with a federal regulatory program.

Seen in this light, Section 310(b)(1) must fail because as a policy matter whether or not it is a generally-applicable

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(NGA Br. 19.) Registration transfer agents do not now have this responsibility (Report at 82), and there is serious question whether statutory authority exists to permit transfer agents to report. (NGA Br. 19.) A depository requirement would have been more effective because there simply would be no physical transfers of bonds. Congress believed relatively untraceable physical transfers of negotiable instruments caused a tax compliance problem. (NGA Br. 17.) But government witnesses conceded that even registered bonds are subject to physical transfer that might be difficult to track. (NGA Br. 18-20.)

regulation, it nonetheless falls within the category identified by the *FERC* Court of impermissible co-option of state regulatory machinery. *FERC* v. *Mississippi*, 456 U.S. at 758-59. Co-option exists when Congress determines that in lieu of establishing a federal regulatory program Congress simply will require the States to use state regulatory powers to achieve the federal purpose.* That is what Congress did in this case. It is impermissible because it distracts state government from the vital role of meeting state citizens' needs in order to meet a federal goal well within the grasp of the separate and independent power given to the federal government by the Constitution.

The Secretary's response, relying on *FERC*, is that Congress could have banned bearer bonds from interstate commerce, and so it could impose the "lesser" intrusion of asking the States to register their debt as a necessary and proper regulation in aid of the taxing powers. (Sec'y Br. 24.) This argument fails to take account of significant factual differences between this case and *FERC*.

FERC involved a challenge to the Public Utility Regulatory Policies Act of 1978 ("PURPA"), enacted by Congress in response to the "nationwide energy crisis" of the 1970's.**

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* Federal co-option of state regulatory machinery also jeopardizes the proper functioning of the political process. The political process functions properly when a legislature is accountable for the burdens it imposes upon regulated entities. When Congress turns to the States to enforce a federal command, the political accountability for a program is separated from the administration of the program. To a private regulated entity, it appears as though the state government is responsible for the regulation, although in fact it is the national Congress that properly should take responsibility for the regulation.

** As indicated in the NGA's main brief, in a situation where federal regulatory authority alone is insufficient to address a national emergency, Congress might be free in limited fashion to seek regulatory assistance from the States (NGA Br. 42-44.) Here, there was no suggestion federal

See FERC, 456 U.S. at 745. Among its other provisions, PURPA required States to "consider" the adoption and implementation of certain regulatory standards. This mandate to consider federal standards differed from Section 310(b)(1) in three critical respects. First, the mandate only was to *consider* federal standards, not adopt them. Second, if a State chose, it might avoid even this minimal intrusion by abandoning the field of energy regulation altogether. *Id.* at 764. Finally, in PURPA the federal government provided funds to mitigate the States' costs of compliance. *Id.* at 751 n.14. All told, rather than pre-empting state authority entirely, as Congress could have done under its commerce power, PURPA established a program of "co-operative federalism." *Id.* at 767 (quoting *Hodel v. Virginia Surface Mining & Recl. Ass'n*, 452 U.S. 264, 284 (1981)).

Section 310(b)(1) shares none of these "co-operative federalism" characteristics of *FERC*. Section 310(b)(1) presented an unavoidable federal mandate.* Moreover because the exercise of state sovereign power at issue under Section 310(b)(1) is not energy regulation, but involves the State's revenue raising authority used to fund critical state projects, Congress could not pre-empt that authority. Conversely, the States could not, as was as possible in *FERC*, "abandon the field" and thereby avoid the federal directive. Finally, unlike *FERC*, in Section 310(b)(1) Congress provided no federal funds to mitigate the regulatory burden, but

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power was insufficient; indeed, the federal government had adequate regulatory means to attack the problem on its own. *See supra* at 10-11.

* Under Section 310(b)(1) the States only could avoid registration by forfeiting the tax exemption. As indicated, *supra* at 4, the Special Master found this "choice" was illusory. (Report at 2.)

required the States to shoulder the entire load. In no sense, therefore, could Section 310(b)(1) properly be termed a "lesser" intrusion than direct federal regulation.

Congress' decision to eschew more effective federal regulatory means in favor of requiring the States to shoulder the burden of addressing a federal agenda item underscores the importance of this case. Increasingly Congress is stepping away from solving its own problems and asking the States to do federal work. Ironically, this occurs at a time when federal contributions to state government are diminishing in proportionate terms. The danger is that the States slowly will be diverted from state agendas and will become administrative federal units. Rather than establishing a program of "cooperative federalism," as *FERC* suggests is permissible, Section 310(b)(1) is a classic example of "co-optive federalism." The NGA respectfully requests that this Court sustain its challenge to the statute.

CONCLUSION

For these reasons, and for the reasons stated in its main brief, the NGA requests that this Court find Section 310(b)(1) an unconstitutional exercise of Congress' power.

Respectfully submitted,

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